



REISus.org
Real Estate Information Standards

Real Estate Investment Standards (REIS)

Debt Valuation: How is the industry valuing debt and communicating the results for 2009?

December 15, 2009

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Introductions



Tim Schlitzer (Moderator):

Massachusetts Pension Reserves Investment Management

Tim is a Senior Investment Officer at the Massachusetts Pension Reserves Investment Management (PRIM) Board. The PRIM Board currently manages over \$40 billion in assets on behalf of the Massachusetts Teachers and Employees. Tim directs the investment activities for PRIM's 10% allocation to real estate and 4% allocation to timberland. His responsibilities include portfolio oversight and manager selection for PRIM's direct real estate, REIT and timberland investments. Tim joined PRIM in 2005 and was previously employed by Grubb & Ellis, a publicly traded commercial real estate services company. He has received an MBA from Northeastern University in Boston, MA, holds a Bachelor of Arts Degree from the University of Massachusetts in Amherst, MA and has completed a Certificate Program in Commercial Real Estate Finance at Boston University.

John Baczewski (Presenter):

Real Estate Fiduciary Services LLC

John is president of Real Estate Fiduciary Services, LLC (REFS), has more than 25 years of experience in institutional real estate investment, finance and management, including investment strategy development, asset strategy development, portfolio and asset management, workouts and re-structuring, due diligence and transaction management, operational reviews, financial management and portfolio monitoring. Professional memberships include NCREIF and PREA, where John chairs the Reporting and Valuation Affinity Group. John serves on the REIS Council and is a fellow of the Homer Hoyt Institute.

Jim Strezewski (Presenter):

LaSalle Investment Management

Jim currently serves as Senior Vice President in LaSalle Investment Management, a global real estate investment manager. Jim has served predominately as the Portfolio Controller for the accounting department during his fifteen year tenure. He has performed both accounting and portfolio management duties on a variety of real estate fund structures and strategies. Jim's prior work experience was in the economy lodging and finance industries. Professional membership includes NCREIF, where he serves as vice-chair of the Accounting Committee.

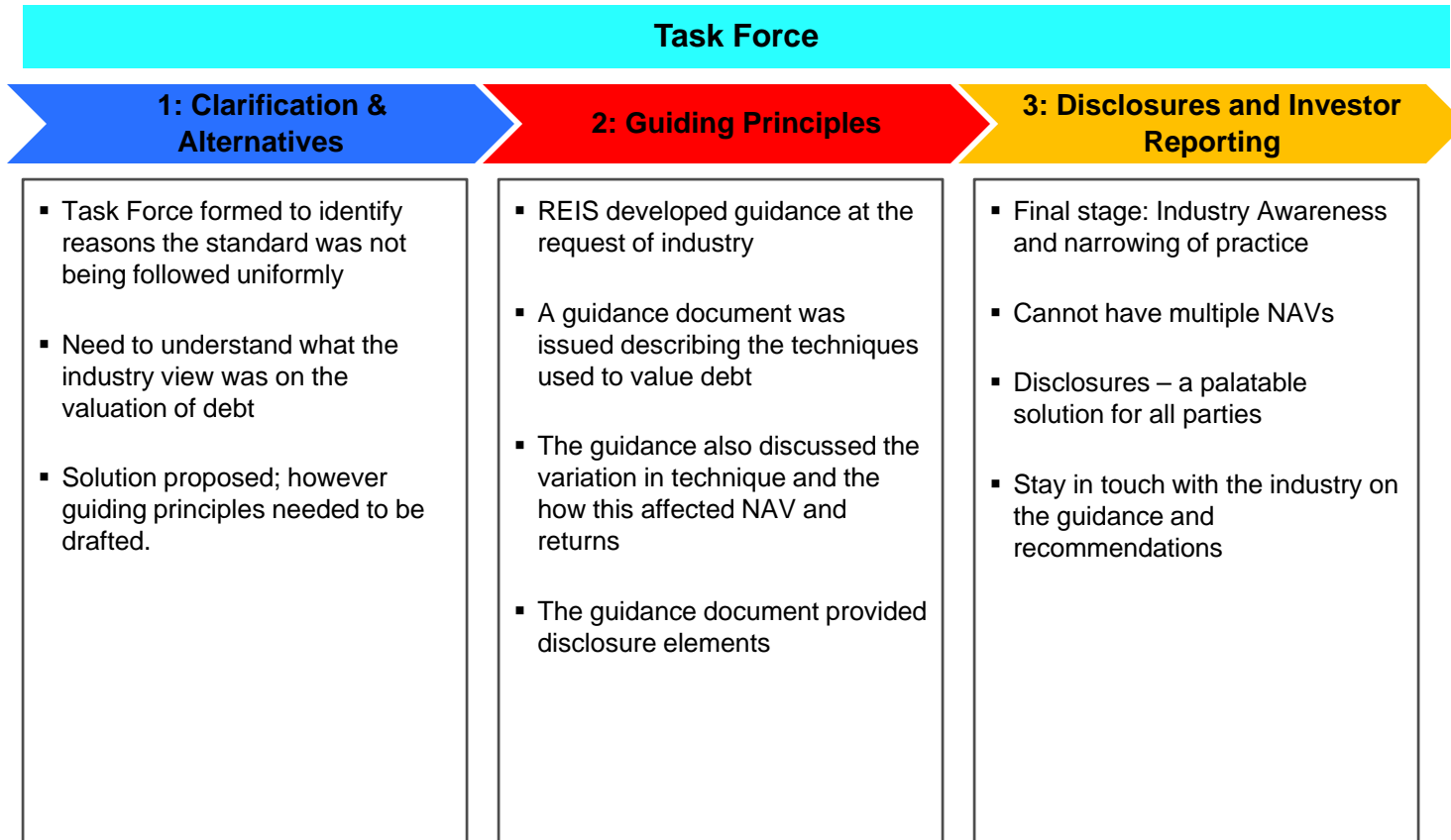


Overview



Overview

REIS, unless precluded by GAAP, has always required debt to be valued on financial statements. In 2008, GAAP was modified to allow debt to be carried at fair value. REIS was updated to conform to this new standard. Industry represented task forces were then formed by REIS to promote comparability around this new standard.



Polling Question #1

Notwithstanding how fair value information is currently reported, do you think the debt associated with encumbered real estate investments should be valued?

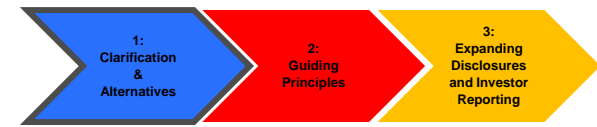
1. Always
2. Sometimes
3. Never
4. Don't know / no opinion



Task Force 1: Clarification & Alternatives



Clarification & Alternatives



The industry was hesitant to move forward with changing REIS to value debt without further guidance.

State of Debt Valuation at First Task Force

- Task Force was not aware of the extent of divergent industry practices
- Industry participants were not necessarily aware of other debt valuation practices
- The REIS standards, although available, were not being uniformly followed

Proposed Solution

- **Open-end funds:** No change from requiring valuation within the Net Asset Value (NAV)
- **Closed-end funds:** Change to recommending valuation within the NAV with required enhanced disclosures
- **Separate accounts:** Change to recommending valuation within the NAV with required enhanced disclosures

Conclusions

- **No change should be considered prior to addressing the guidelines and disclosures** although expansion of REIS compliance was an agreeable goal.
- Expanded disclosures subject to audit
- Plan Sponsors could require REIS compliance and Investment Managers could achieve compliance (REIS Checklist)



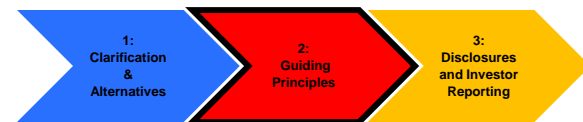
Item	Yes	No
1.01. Is the fund a REIT?	Yes	No
1.02. Is the fund a common fund?	Yes	No
1.03. Is the fund a private equity fund?	Yes	No
1.04. Is the fund a hedge fund?	Yes	No
1.05. Is the fund a multi-strategy fund?	Yes	No
1.06. Is the fund a real estate debt fund?	Yes	No
1.07. Is the fund a real estate equity fund?	Yes	No
1.08. Is the fund a real estate private equity fund?	Yes	No
1.09. Is the fund a real estate hedge fund?	Yes	No
1.10. Is the fund a real estate multi-strategy fund?	Yes	No
1.11. Is the fund a real estate private equity fund?	Yes	No
1.12. Is the fund a real estate hedge fund?	Yes	No
1.13. Is the fund a real estate multi-strategy fund?	Yes	No
1.14. Is the fund a real estate private equity fund?	Yes	No
1.15. Is the fund a real estate hedge fund?	Yes	No
1.16. Is the fund a real estate multi-strategy fund?	Yes	No
1.17. Is the fund a real estate private equity fund?	Yes	No
1.18. Is the fund a real estate hedge fund?	Yes	No
1.19. Is the fund a real estate multi-strategy fund?	Yes	No
1.20. Is the fund a real estate private equity fund?	Yes	No



Task Force 2: Guiding Principles



Task Force 2: Overview

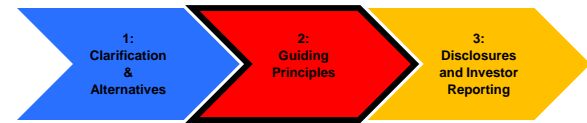


The second task force was formed out of necessity from the first.

<p>Goals</p>	<ul style="list-style-type: none"> ▪ Facilitate application of Topic 820 (FAS 157) across the industry <ul style="list-style-type: none"> ▪ Our product changed from definitive guidance to a fair representation of current practice because industry participants had selected valuation policies, yet there was no dominant approach ▪ Guidance should be methodological, rather than prescriptive. ▪ Produce a document that: <ul style="list-style-type: none"> - Narrows the practice - Improves overall information data set and comparability and, - Promotes REIS compliance
<p>Guiding Principles</p>	<ul style="list-style-type: none"> ▪ Fair Value Accounting model has been selected, therefore Topic 820 (FAS 157) Fair Value Measurements is applicable ▪ Goal of unqualified opinion remains paramount ▪ Conscious choices are required ---benign neglect is not an option
<p>Conclusions</p>	<ul style="list-style-type: none"> ▪ Existing REIS property valuation standards function effectively for free and clear real estate ▪ Traditional fixed income math values the receivable quite effectively <ul style="list-style-type: none"> - The liability isn't necessarily the same value, but this answer is a valuable input in assessing its impact on the equity. ▪ Industry has implemented three views of Note/Mortgage Payable valuation <ul style="list-style-type: none"> - Gross - Net - Benign neglect - Do nothing
<p>Recommendations</p>	<ul style="list-style-type: none"> ▪ A method once chosen should be consistently applied at each of the property, investment and fund levels. ▪ Methodologies, processes and assumptions should be disclosed. ▪ In addition to the disclosures required under the accounting guidance for fair value measurements, performance attribution data resulting from implementing ASC Topic 820 should be isolated and identified separately within the appreciation component of the time-weighted return calculation.



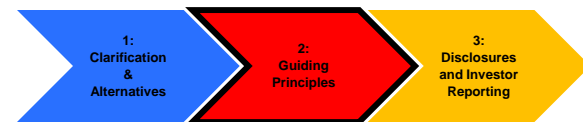
Methods Gross vs. Net



Gross	Net	Difference
<ul style="list-style-type: none"> ▪ Have a rules-based view of ASC Topic 820 ▪ Argue that there are two units of account (one for the asset and one for the liability). Believe FASB Accounting Standards Update No. 2009-05, <i>Measuring Liabilities at Fair Value</i> (now included in ASC Topic 820, Subtopic 10, Sections 35, 55 & 65) <i>drives the view of market participant behavior.</i> ▪ Value the liability (obligation to make a stream of cash payments), assuming a hypothetical transaction where the reporting entity pays a “credit equivalent” market participant to assume the liability (the liability continues, it is not settled). The amount paid in such a transfer is dependent upon changes in market conditions since the issuance of the liability. ▪ Use different market proxies for the sale of assets and the transfer/issuance of liabilities and these markets have different participants, requiring these elements to be separate units of account ▪ Value the asset on a free and clear basis 	<ul style="list-style-type: none"> ▪ Have a principles-based view of ASC Topic 820 ▪ Argue there is one unit of account ▪ Believe the AICPA Audit and Accounting Guide –<i>Audits of Investment Companies</i> (the Investment Company Guide) is the accounting pronouncement which supports a single unit of account for encumbered real estate investments. Under the Investment Company Guide, consolidation and equity method accounting are not allowed. View the reporting presentation which separately shows both components of the investment (asset and liability) is an argument of form over substance and does not impact unit of account or market participant considerations. ▪ Value the liability in the context of its impact on cash flows to the net equity position ▪ Believe the market proxy is trades of equity positions in levered investments. ▪ Value the asset on a free and clear basis 	<ul style="list-style-type: none"> ▪ Differences in views create differences in: <ul style="list-style-type: none"> - Net Asset Value - Total Return ▪ Where: <ul style="list-style-type: none"> - Investment strategy is similar - Underlying economic performance is similar



Leveraged Property Example



Asset assumptions for the quarter:

Non-operating accounting model where net method allows for par value of **non-assumable** debt.

Asset value (BOP):	\$ 60,000,000	Asset Value (EOP):	\$ 60,500,000
Loan Balance (Debt is not assumable):	\$ 40,000,000	Debt Fair Value (EOP, via NPV):	\$ 39,350,180
Loan/Market interest rate (BOP):	5.00%	Market interest rate (EOP):	5.25%
Net Operating Income :	\$ 800,000	Debt Service:	\$ 500,000

Gross	Numerator is:	$\$1,449,820 = (60,500,000 - 60,000,000) - (39,350,180 - 40,000,000) + (800,000 - 500,000)$
	Denominator is:	$\$19,901,000 = (60,000,000 - 40,000,000) - .33 * (800,000 - 500,000)$
	Return is:	7.29%

Net	Numerator is:	$\$800,000 = (60,500,000 - 60,000,000) - (40,000,000 - 40,000,000) + (800,000 - 500,000)$
	Denominator is:	$\$19,901,000 = (60,000,000 - 40,000,000) - .33 * (800,000 - 500,000)$
	Return is:	4.02%

Conclusion:

A financial statement preparer who chooses the net method, and therefore records par value as the value of the debt, will have a different value than a preparer who chose the gross method which ignores the restrictions on valuing non-assumable debt.

The results are two different returns – for the same asset!



Polling Question #2

Irrespective of how the fair value of debt is currently calculated, which view would you choose to value debt?

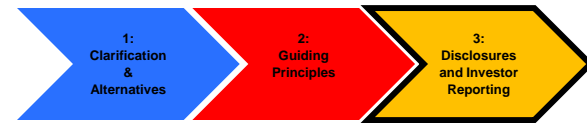
1. Gross view
2. Net view
3. Practical expedient (share of NAV)
4. A combination of the net, gross, and practical expedient
5. Would not value the debt in any situation
6. Don't know / No opinion



Task Force 3: Disclosures & Investor Reporting



Expanded disclosures



Building industry participants' awareness about REIS guiding principles on ASC820 will provide greater transparency, reliability and measurability of financial statements. Task Force 3 focused on expanded disclosure elements and investor reporting.

Disclosures

Transparency

- Methods – how you value debt.
 - Gross
 - Net
 - Practical Expedient
 - Debt Not Valued

Reliability

- Disclosures are **subject to audit**
- Results are subject to a **industry standard** with respect to methodology
- Fosters **comparability and narrows practice**

Measurability

- Attribution Analysis
- Information is readily available for assessment and decision making

Benefits

- Investors now know “how” the numbers are calculated for their investments
- Investors now understand the differences

- Third party verification on accuracy
- Standard methods produce comparable results

- Investors can assess the effect in financial statements and on returns
- There is no longer a need to dig for information



Reporting



Guidelines for the elements to be included in the disclosures are discussed within the guidance documents and this presentation. Investor reporting becomes particularly important when investors have competing perspectives. The standardization of this process also provides needed clarity for all investors.

Industry Disclosures Elements

- **Methods used in calculations: Gross, Net, Practical Expedient, Nothing**
- **Each financial statement line item that is valued should indicate the effect on NAV**
- **Provide an understanding of unconsolidated investments at value**

Communication to Investors

- **Footnotes (above)**
- **Performance Measurement**
 - **Some attribution analysis to isolate the effect on returns**
- **Investor Reporting**
 - **This is what institutional investors want**
 - **Fund Reporting Standards – a REIS document**



Polling Question #3

Do you think the elements of expanded disclosures suggested in this presentation are helpful for understanding debt valuation and facilitating comparisons?

1. Extremely
2. A good start
3. Go back to the drawing board
4. Don't know / No opinion



Polling Question #4

Do you support providing these disclosures in your 2009 year-end reports you prepare or use?

1. Yes
2. No
3. Maybe
4. Don't know / No opinion



Summary



Summary

Accomplishments

- Listened to the industry “cries for help”
- Identified the dominant techniques for valuing debt
- Outlined the elements of disclosures necessary to facilitate investor understanding

Next Steps

- Evaluate industry 2009 implementation
- Revisit with industry participants and assess the usefulness of the recommendations
- Continue REIS mission to narrow the practice over time



Polling Question #5

After what you have heard today, and irrespective of how fair value information is currently reported, do you think the debt associated with encumbered real estate investments should be valued?

1. Always
2. Sometimes
3. Never
4. Don't know / No opinion



Contact Information

John Baczewski:

Real Estate Fiduciary Services LLC

jib@refiduciaries.com

Marybeth Kronenwetter:

REIS Administrator

marybeth@reisus.org

Tim Schlitzer:

Massachusetts Pension Reserves Investment Management

tschlitzer@mapension.com

Jim Strezewski:

LaSalle Investment Management

james.strezewski@lasalle.com



Questions



Data Sources

- **REIS (Real Estate Information Standards) Website**
<http://www.reisus.org>
- **Real Estate Information Standards (REIS)**
[http://www.reisus.org/files/Real Etstae Information Standards as of103009 for posting 2 .pdf](http://www.reisus.org/files/Real_Etstae_Information_Standards_as_of103009_for_posting_2_.pdf)
- **REIS Checklist**
[http://www.reisus.org/files/REIS Checklist appendix 4 of standards doc as of 032609.xls](http://www.reisus.org/files/REIS_Checklist_appendix_4_of_standards_doc_as_of_032609.xls)
- **ASC Topic 820 Implementation Guidance for Real Estate Investments**
[http://www.reisus.org/files/REIS Checklist appendix 4 of standards doc as of 032609.xls](http://www.reisus.org/files/REIS_Checklist_appendix_4_of_standards_doc_as_of_032609.xls)
- **REIS News (available monthly)**
<http://www.reisus.org/News.html>
- **NCREIF (National Council of Real Estate Investment Fiduciaries) Website**
<http://www.ncreif.org>
- **PREA (Pension Real Estate Association) Website**
<http://www.prea.org/>



Polling results

Polling question 1:

Notwithstanding how fair value information is currently reported, do you think the debt associated with encumbered real estate investments should be valued?

Always	69	51%
Sometimes	51	38%
Never	7	5%
Don't know / No opinion	7	5%

Polling question 2:

Irrespective of how the fair value of debt is currently calculated, which view would you choose to value debt?

Gross view	53	44%
Net view	34	28%
Practical expedient (share of NAV)	5	4%
A combination of Gross, Net, and Practical Expedient	15	12%
Would not value debt in any situation	2	2%
Don't know / No opinion	12	10%

Polling question 3:

Do you think the elements of expanded disclosures suggested in this presentation are helpful for understanding debt valuation and facilitating comparisons?

Extremely	19	15%
A good start	91	72%
Go back to the drawing board	10	8%
Don't know / No opinion	7	6%

Polling question 4:

Do you support providing these disclosures in your 2009 year-end reports that you prepare or use?

Yes	60	53%
No	13	12%
Maybe	34	30%
Don't know / No opinion	6	5%

Polling question 5:

After what you have heard today, and irrespective of how fair value information is currently reported, do you think the debt associated with encumbered real estate investments should be valued?

Always	69	59%
Sometimes	35	30%
Never	9	8%
Don't know / No opinion	4	3%

