
Debt Valuation Task Force

A Survey of Investment Manager
Perspective and Practice

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Debt Valuation's Recent History

FASB 157 and 159 Impact Accounting and Reporting in a Fair Value Environment

- **In 2007**, the FASB issued SFAS 157, *Fair Value Measurements* and SFAS 159, *Fair Value Option For Financial Assets and Liabilities*, with effective dates for periods beginning after 11/15/07. Important points discussed in the documents are:
 - the adequacy of fund Net Asset Value (NAV), and
 - the appropriateness of the policies and procedures used by fund managers to value the underlying assets and liabilities
- Under certain circumstances, calendar year private companies may have until 12/31/08 to elect SFAS 159.

The current REIS Standard requires all notes payable to be carried at fair value

- Real Estate Information Standards (REIS)
 - Sponsored by NCREIF and PREA
 - REIS Board serves as governing body
 - Mission: disclose reliable, useful, comparable, transparent and meaningful information relevant to decision-making processes which can be independently verified.
 - Set of cross-disciplinary information standards for the institutional real estate industry
 - Fair value accounting
 - Valuation
 - Performance measurement and
 - Reporting standards

... yet practice is uneven

- Current REIS standard
 - Notes payable are required to be carried at fair value
 - In order to be in compliance with REIS, SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities-including an amendment to FASB Statement 115*, must be elected for each note payable instrument held.

- It was apparent that there was a spectrum of practices surrounding election of the Fair Value Option in the IM community, and therefore, uneven adherence to the REIS standard.

Widespread IM participation and representation in the survey process

- Designed short survey of debt perspective by investment structure and strategy
 - Intended to be value neutral, approved with suggestions incorporated by Advisory Board
 - Interviewers at times collected narrative comments; to tabulate qualitative responses would infer a frequency or importance that may not have been intended by interviewee
- Explanatory cover letter and questions set to NCREIF and PREA IM representatives
- Task force successfully interviewed 32 IM firms representing nearly \$433 billion in U.S. Real Estate Private Equity Investments (NAV of approximately \$239 billion)
 - 18 of the top 20 IM firms (based on assets under management) as measured by Pensions and Investments (P&I) were interviewed.
 - IM firms identified by:
 - P&I online directory
 - Advisory Board
 - Task Force Participants
- Confidentiality and neutrality emphasized
- Experienced positive and enthusiastic participation

Investment Manager Survey Results

IM Summary Demographics:

32 firms; \$239 billion NAV

■ Number of Respondents: 32

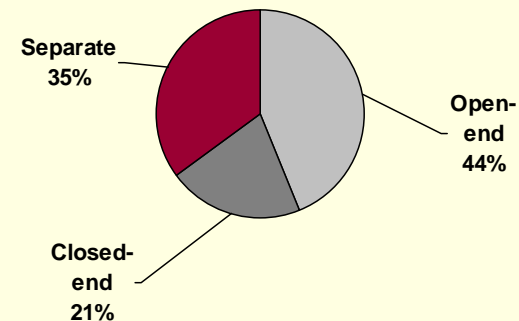
■ Approximate NAV by Fund Structure:

■ Open-end commingled funds	\$105 (44%)
■ Closed-end commingled funds	\$ 49 (21%)
■ Separate Accounts	\$ 85 (35%)

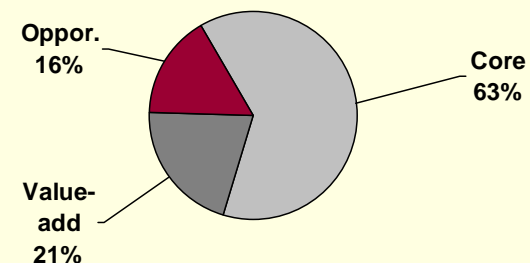
■ Approximate NAV by Fund Strategy:

■ Core	\$149 (63%)
■ Value Add	\$ 51 (21%)
■ Opportunistic	\$ 39 (16%)

Representation by NAV



Representation by Strategy



Majority of Investment Managers find valuation of all debt in all circumstances is not appropriate

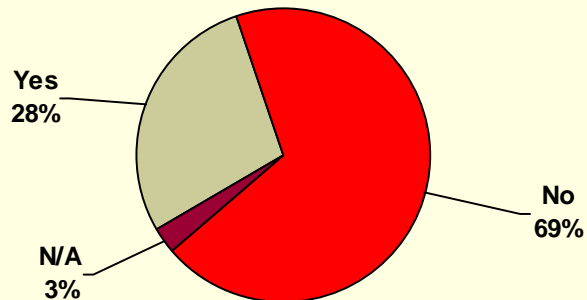
Given the recent release of FASB/AICPA standards, do you think the valuation of all debt in all circumstances is appropriate

■ **Based Upon Number of Respondents (32):**

■ Yes	28%
■ No	69%
■ N/A*	3%

* One respondent does not use leverage

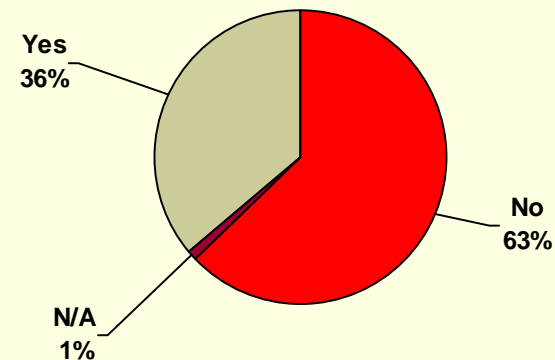
Representation by number of respondents



■ **Based Upon Plan Total Private Real Estate Assets (\$239 billion):**

■ Yes	36%
■ No	63%
■ N/A*	1%

Representation by NAV



Reasons exist on both sides; reasons to value or not sometimes contradict each other

Please explain circumstances where you think the valuation of debt is...

Appropriate

- When there are willing buyers and sellers
- Open end funds (trading)
- When debt is assumable – either directly or indirectly
- When plan sponsors demand it for separate accounts
- For all separate accounts
- Any time when the fund has a unit price (both open and closed)
- If there is an assumption that in some cases cost and market can be the same (e.g. floating rate)
- Whenever an investment is valued – must value asset and liability
- In order to be REIS compliant
- When a disposition is contemplated
- For all discretionary funds
- When using the Investment Company Guide model
- In all cases in order to provide transparency
- In all cases because investment value should be the same regardless of fund structure
- If the benchmark requires debt valuation

Not Appropriate

- Closed-end funds and separate accounts
 - No trading
 - Debt held to maturity
 - Value is not indicative of liquidation value
 - Valuation cannot be monetized currently
 - Creates timing differences and confusion to investors
- When debt is not accretive or dilutive to value
- Because it adds volatility
- When the debt is not assumable
- Because FAS 159 is an option
- Because it adds confusion to reported results
- Because the market quotes for debt lack consistency – problems with how to value debt
- When the holding period is short
- When Fund is IRR driven (might not value asset either)
- In the current economic environment
- For portfolio level debt – amount is expected to be settled at par or is too short of term
- If the benchmark does not require debt valuation
- Because there is no clear methodology with respect to how to value debt

Some interesting additional facts unearthed about the appropriateness of debt valuation in all cases

- Every manager with an open-end fund reported that the valuation of debt is always appropriate for an open-end fund.
- Fund structure was by far the predominant factor when considering whether or not to value debt.
- Fund strategy was generally not mentioned as a factor which should be considered when making the debt valuation determination.
- At least one IM reported that a separate account client specifically instructed the manager not to value debt; however in some cases, IM's reported they were instructed by clients to value debt.

Practice of election to value debt is a split decision – many IMs value debt even though they think it is inappropriate

Has your firm elected to value debt for all of the wholly-owned & consolidated investments, and JV/Equity method investments, in your commingled funds and separate accounts?

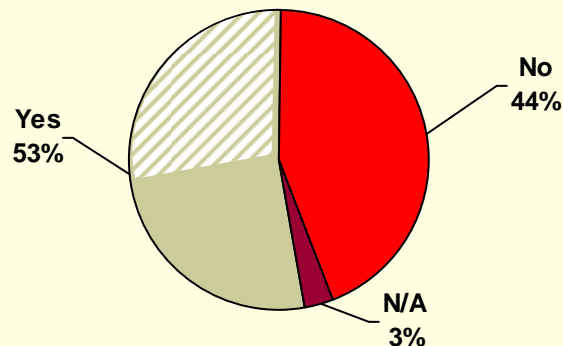
■ Based Upon Number of Respondents (32):

■ Yes	53%
■ No	44%
■ No response	3%

■ Based Upon Plan Total Private Real Estate Assets (\$239 billion):

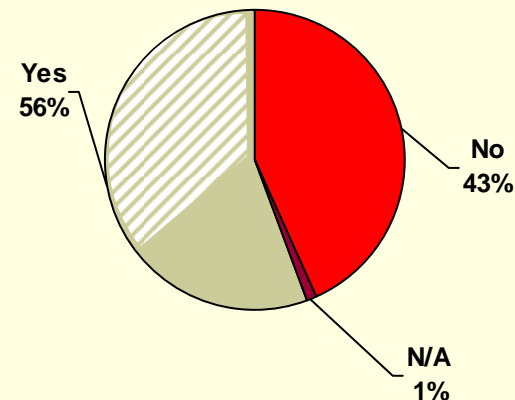
■ Yes	56%
■ No	43%
■ N/A	1%

Based on number of respondents



Note: 28% said it was appropriate yet 53% have elected

Based on NAV



Note: 36% said it was appropriate yet 56% have elected

Generally, SFAS 159, The Fair Value Option, did not change the IMs' perspective on debt valuation

Did your firm's perspective on the valuation of debt change after the effective date of FAS 159?

■ Based Upon Number of Respondents (32):

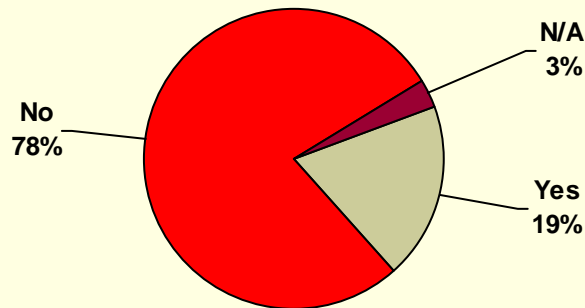
■ Yes	19%
■ No	78%
■ N/A*	3%

■ Based Upon Plan Total Private Real Estate Assets (\$239 billion):

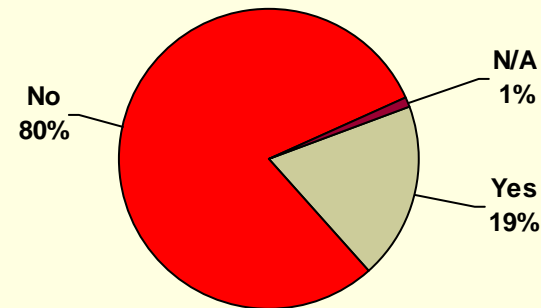
■ Yes	19%
■ No	80%
■ N/A*	1%

* One respondent does not use leverage

Based on number of respondents



Based on NAV



Although SFAS 159 generally did not change the IM's perspective about debt valuation, the reasons given by those who made changes were...

- In order to value **all** debt in open-end funds accounted for under the Investment Company Guide
 - Previously precluded from valuing portfolio level debt
- In order to be in compliance with REIS
- Required to do so by separate account investors – either current policy or newly required
 - Generally a result of recent discussions about 159 for recent changes to separate account policies

Most IMs are addressing FAS 159 and debt valuation with investors, but not always

Has your firm discussed the concept of debt valuation as it relates to FAS 159 with investors?

■ Based Upon Number of Respondents (32):

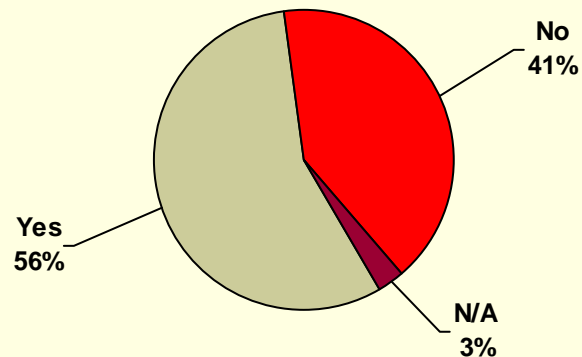
■ Yes	56%
■ No	41%
■ N/A *	3%

■ Based Upon Plan Total Private Real Estate Assets (\$239 billion):

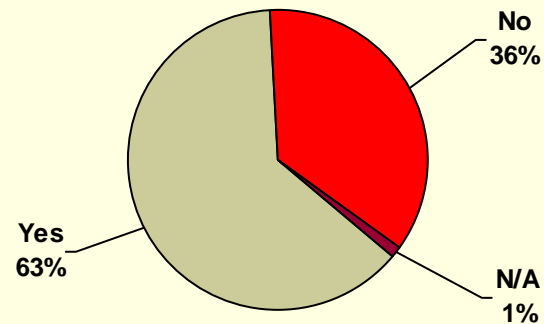
■ Yes	63%
■ No	36%
■ N/A*	1%

* One respondent does not use leverage

Based on number of respondents



Based on NAV



What role did the REIS Standard play in the IM's decision to value debt?

1. Did the notion of compliance with the REIS Standard (to value all debt) influence your decision:

■ For open-end funds (20)?

- Yes 40%
- No 60%

■ Separate accounts (26)?

- Yes 42%
- No 58%

■ For closed-end funds (26)?

- Yes 27%
- No 73%

■ Other (8)?

- Yes 13%
- No 88%

2. Does your firm believe the current REIS standard is appropriate for:

■ All fund structures (31):

- Yes 39%
- No 61%

■ All fund strategies (28)

- Yes 39%
- No 61%

■ All investor classes (25)

- Yes 48%
- No 52%

Note: Calculated on number of respondents

Where IMs decisions were not based on REIS, suggested ways to change the current standard were...

- Standard should be applied when debt can be traded
- Required for open-end funds only
- Recommend for closed-end funds
- Required footnote disclosure of debt valuation
- Do not interpret GAAP – there is optionality in SFAS 159
- Provide guidance to address the issues of transferability and loan prepayment penalties
- Address materiality
- Provide specific guidance for portfolio level debt
- Address situations where cost appropriately approximates value
- Do not require for debt associated with properties under development

When IMs were asked about debt valuation by fund structure, practice varied widely

By vehicle – Is debt valued in the fund

% of NAV	Closed-end funds (\$49 Billion)	Open-end funds (\$105 Billion)	Separate accounts (\$85 Billion)
■ Yes	42%	100%	57%
■ Some	8%	0%	1%
■ No	49%	0%	38%
■ N/A	1%	0%	4%

Number of Managers	Closed-end funds (28)	Open-end funds (19)	Separate accounts (23)
■ Yes	43%	100%	47%
■ Some	11%	0%	4%
■ No	42%	0%	40%
■ N/A	4%	0%	9%

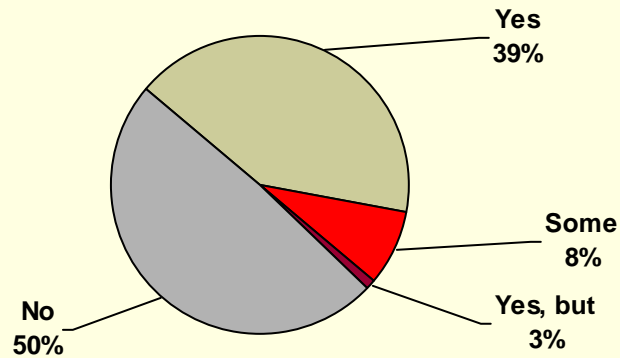
Notes:

- The majority of respondents for closed-end funds thought it was appropriate to value debt for all structures.
- One respondent did not have any debt and was classified as N/A above.

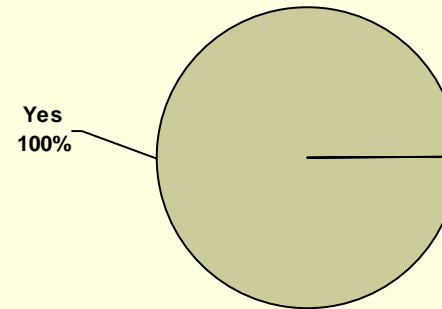
Structure results by NAV (\$239 billion)

By vehicle – all debt in the fund is valued

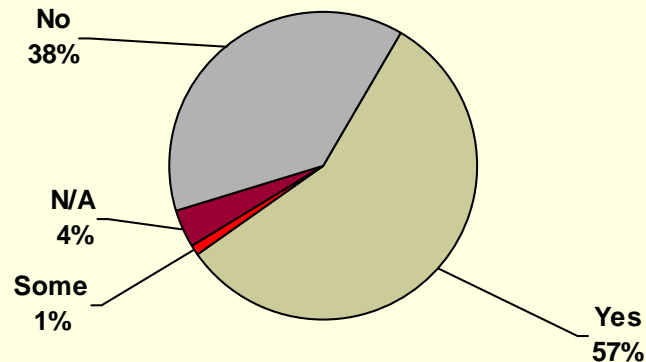
Closed-end Funds (\$49 billion)



Open-end Funds (\$105 billion)



Separate Accounts (\$85 billion)



Additional Information Gathered

Some IMs are reporting more “supplemental” information on debt

Who is asking:

- Consultants: showing time-weighted returns attributable to the real estate separate from the debt
- Separate account investors: showing calculations on debt valuations

Other supplemental information being provided:

- Comprehensive disclosure of debt valuation policy
- Detailed valuation of debt on properties contemplated for sale
- GIPS composite reporting (suggested practice) - show consistent policy with respect to debt valuation for all accounts included within a composite

IMs that have funds which report using IFRS or other non-U.S. GAAP generally do not value debt on those funds

1. Does your firm have any funds that report on a basis of accounting other than U.S. GAAP?

■ Based Upon Number of Respondents (32):

- Yes 38%
- No 56%
- No response 6%

■ Based Upon Plan Total Private Real Estate Assets (\$239 billion):

- Yes 37%
- No 52%
- N/A 11%

2. For each other basis of accounting used, is debt valued in the financial statements of these funds? Always? Sometimes? Never?

■ Based Upon Number of Respondents (12)?

- Yes 17%
- No 58%
- Sometimes 17%
- N/A 8%

Industry issues to consider

- REIS should address requested guidance for **HOW** debt should be valued: work quickly and aggressively
- REIS needs more penetration – some opportunity fund managers are unfamiliar with REIS
- REIS to provide more direction with disclosure requirements
- Complete REIS compliance checklist initiative

Investment Manager Conclusion of the Task Force for REIS Council and Board consideration:

- REIS should adjust the requirement to value debt to a structure based decision. Based on survey results, the following seems appropriate:
 - **Open-end funds:** Required valuation and adoption of 159 coupled with enhanced disclosures
 - **Closed-end funds:** Recommended valuation with required enhanced disclosures
 - **Separate accounts** : Recommended valuation with required enhanced disclosures (where IM has the choice)
- Reasons for this conclusion:
 - REIS should not force application where GAAP does not
 - If separate account investors require that debt be valued, it can be done
 - REIS needs to be more industry encompassing
- Cannot make current year (2008) change to REIS, but next steps should be...
 - Not enough information on what “enhanced disclosures” might look like at this point
 - An immediate exposure draft process (not a conforming change) - industry review
 - Potential guidelines addressing how debt should be valued for our industry

Investment Manager and Task Force Participants

IM Interviewees

32 Firms; \$239 billion (NAV) in U.S. Real Estate Private Equity Investments

AEW	Henderson Global Investors, NA
AMB Capital Partners	ING
American Realty Advisors	Invesco
BlackRock	JER
Blackstone	JP Morgan
The Campbell Group, LLC	Kennedy Associates
CB Richard Ellis Investors	Kimco
Citigroup	LaSalle Investment Management
Colony Capital	Lowe Enterprises
Cornerstone	Morgan Stanley
Edens and Avant	Principal
Forest Investments	Prudential
Goldman Sachs (Whitehall Funds)	RREEF
Guggenheim	Sentinel
Hart Realty Advisers	UBS
Heitman	Urdang

Advisory Group Participants

Chair

Doug Poutasse, Executive Director, *NCREIF* and Chair, *REIS Board*

Jeff Kiley	Partner	<i>PricewaterhouseCoopers</i>
Tom Mulvin	Investment Officer	<i>Virginia Retirement System</i>
Joe Pagliari*	Clinical Professor of Real Estate	<i>University of Chicago Graduate School of Business</i>
Kevin Scherer	Managing Director	<i>BlackRock</i>
Lynn Thurber*	Chairman	<i>LaSalle Investment Management</i>

*REIS Board Member

Task Force Participants

Chair

Jim Strezewski, Senior Vice President, *LaSalle Investment Management*

Co-Chair

Monica Parikh, Director of Research, *Metzler, North America*

REIS Administrator

Marybeth Kronenwetter, President, *Real Estate Investment Advisors*

Lindsey Adams	Vice President, Portfolio Manager	<i>AMB Capital Partners, LLC</i>
Sara Geiger	Portfolio Manager, Real Estate	<i>Florida State Board of Administration</i>
Ken Greguski*	Director, Global Head of Performance/Client Reporting	<i>RREEF Alternative Investments</i>
Denisa Hall,	Vice President	<i>Prudential Real Estate Investors</i>
Barbara McDowell*	Director, Portfolio Analytics	<i>ORG Portfolio Management</i>
Michael Morrell	Assistant Manager of Real Estate/Asset Management	<i>NYSTRS</i>
Brian Rueben	Partner	<i>Deloitte</i>
Ashley Strange	Private Markets	<i>TRS of Texas</i>
Connie Tirondola	Director, Portfolio Accounting	<i>BlackRock</i>
Candice Todd*	Executive Director	<i>Morgan Stanley Real Estate</i>
Serena Wolfe	Senior Manager	<i>Ernst & Young</i>

* REIS Council Member