
**FASB ASC Topic 820, *Fair Value Measurements and Disclosures*:
Implementation Guidance for Real Estate Investments**
A REIS Guidance Document

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The REIS Board and Council would like to thank the following individuals and their organizations who participated in this project¹.

Task Force Chair

Name	Title/Firm	Professional Expertise
John Baczewski*	<i>President, Real Estate Fiduciary Services</i>	Generalist

Task Force Members

Name	Firm	Professional Expertise
Neal Armstrong*	<i>Director Fund Finance, RREEF</i>	Accounting
Peter Bloomfield	<i>Partner, KPMG</i>	Accounting
David Blum	<i>Managing Director, Urdang</i>	Portfolio Management
Stan Dennis	<i>Senior Managing Director, US Institutional Accounts, Valuation Services, Cushman & Wakefield</i>	Valuation
Gavin Duckworth	<i>Consultant, Chatham Financial</i>	Debt Valuation
Dan Enright	<i>Investment Officer, CalPERS</i>	Valuation
Bruce Frank*	<i>Partner, Ernst & Young</i>	Accounting
David Friedman	<i>Managing Director, Wrightwood Capital</i>	Portfolio Management
Marybeth Kronenwetter	<i>President, Real Estate Investment Advisors, Inc</i>	REIS Administrator
Dave MacDonald	<i>Vice President, State Street</i>	Performance Measurement
Robert Mangrelli	<i>Consultant, Chatham Financial</i>	Accounting
Alice Pineiro	<i>Self-employed</i>	Performance Measurement
Tom Trinter	<i>Consultant, Chatham Financial</i>	Debt Valuation
Jeff Walker	<i>Principal and Managing Director, US Realty Consultants</i>	Valuation
Serena Wolfe	<i>Senior Manager, Ernst & Young</i>	Accounting

*REIS Council Voting Member

The task force wishes to acknowledge the contributions and guidance received from its advisory group: Jeff Kiley*, Partner, PricewaterhouseCoopers; Doug Poutasse, REIS Board Chair; Kevin Scherer, Executive Director, BlackRock; and Lynn Thurber, REIS Board Member.

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I. EXECUTIVE SUMMARY

This implementation guide for FASB Accounting Standards Codification Topic 820, *Fair Value Measurements and Disclosures* (ASC Topic 820) (previously Statement of Financial Accounting Standards No. 157- Fair Value Measurements, or “FAS 157”), was developed for several reasons: first: the FASB writes guidance for the broad capital markets not private market real estate investment specifically; second, since issuance, the accounting guidance for fair value measurements has been and continues to be the subject of numerous updates, and diverse implementation approaches throughout the industry; third, this document represents a step in the process of U.S GAAP “catching up” with fair value accounting, which has been practiced within our industry since its inception; finally, the REIS team initiated this activity in response to widespread industry discussions, and prior task force work.

During the preparation of this document, the rules have been ever-changing, and the accounting guidance for fair value measurements has been amended numerous times. We anticipate that such amendments, and “fine -- tuning” will continue. On July 1, 2009, FAS 157 was codified into ASC Topic 820. This work has also occurred against the backdrop of a tumultuous marketplace in which values were declining and the process of value discovery was increasingly difficult due to a paucity of transactions. Nevertheless, task force efforts were focused on preparing guidance designed to stand the test of time.

Within [REIS](#), this pronouncement applies to both prevalent financial reporting models and all financial statement elements. During its work, the task force observed that both the gross and net views of debt valuation were applied by entities reporting under each of the operating and non-operating reporting models. If one is model dependent it is possible that within an entity’s financial statements, fair value information could be determined utilizing both the gross and net views. Significant portions of the task force debate and deliberations focused on the valuation of debt -- from the perspective of the borrower, which emerged as a clear point of the approach and process differentiation. There are two schools of thought when implementing ASC Topic 820 and applying it to mortgages and notes payable

- Holders of the net view:
 - Take a principles based implementation approach to ASC Topic 820-a principles based standard
 - Argue there is one unit of account
 - Believe the AICPA Audit and Accounting Guide – *Audits of Investment Companies* (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.

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- Value the asset on a free and clear basis
 - Holders of the gross view
 - Take a rules based implementation approach to ASC Topic 820 – a principles based standard
 - 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, *Measuring Liabilities at Fair Value* (now included in ASC Topic 820, Subtopic 10, Sections 35, 55 & 65) drives the view of market participant behavior.
 - 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

Our task force, much like the marketplace, was evenly divided regarding which method should be preferred. This circumstance creates an environment in which the application of multiple methodologies can result in different net asset values for investment vehicles pursuing similar investment strategies. Therefore, the balance of this document focuses on explaining the logic of the calculations and considerations which underlie both methods for valuing debt. In addition, disclosures to provide financial statement users adequate information to understand differences arising from the described methodologies are recommended.

For purposes of valuing wholly-owned real estate positions, this task force relied on information appearing in chapter 1 of the Real Estate Information Standards (REIS). The valuation of mortgages and notes receivable using the income approach has been included in Appendix 5. The task force acknowledges that valuation methodologies can vary and elements considered may differ. Therefore, methodology illustrations included in this guidance document are not intended to be exhaustive. Industry participants must reach their own conclusions based on relevant facts and circumstances.

Guidance:

As a result of its work, the task force recommends the following policies for fund reporting purposes:

- 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.

This guidance is not a substitute for reading and understanding relevant professional literature, related entity governing documents, and transaction level documentation. Professional judgment must be exercised when considering various alternatives for valuation, accounting and disclosures.

The provisions of this guidance document need not be applied to immaterial items.

The task force anticipates that as familiarity with implementing these concepts expands the related debt valuation practices will narrow.

II. INTRODUCTION

Background

The provisions of [FAS 157](#) became effective for fiscal years beginning after November 15, 2007. Since that time, the FASB has issued application guidance for FAS 157 in the form of several FASB Staff Positions (FSPs). (Included as Appendix 1 is a summary of the FSPs issued to date.) FAS 157 is a principles-based standard intended to provide a framework for measuring fair value within U.S. GAAP. This framework introduces, or reiterates, a number of key concepts including unit of account, exit price, valuation premise, highest and best use, principal market, market participant behavior, and the fair value hierarchy, which form the foundation of the fair value measurement approach to be utilized for financial reporting purposes. Varied interpretations currently exist with respect to how certain of these concepts should be applied, particularly unit of account and market participant behavior. These differences have resulted in widespread non-comparable reporting of real estate investment performance within our industry.

Although, as of December 31, 2008, industry participants had already adopted the provisions of FAS 157 and as such have initially interpreted how debt should be valued, these FSPs have highlighted some of the challenges faced by organizations implementing the provisions of FAS 157. More guidance is necessary and is expected to be forthcoming from the FASB; however, the guidance provided may not target the private institutional real estate investment industry. Interpretations of FAS 157 vary within our industry. In some cases, reported net asset values (NAVs) can differ across funds pursuing similar investment strategies, even when the underlying economics are essentially the same. During the process of developing guidance for the implementation of FAS 157, the Task Force observed that FAS 157 interpretations with respect to debt valuation have varied across the major accounting firms. Since our industry has affirmed that unqualified opinions are of paramount importance, this guidance document acknowledges the diverging views and practices. A side-by-side comparison of valuation considerations under two different approaches for debt valuation is provided. In addition, detailed explanations and selected situational examples illustrating how differences arise are provided. Investor reporting disclosures are suggested which help facilitate analysis by those making capital allocation decisions. As discussions surrounding debt valuation continue within the FASB, public

accounting firms and industry groups, the REIS Board and Council expect this guidance document will stimulate discussion and analysis and provide guidance for disclosures necessary to help narrow related industry practices.

On July 1, 2009, FAS 157 and the aforementioned FSP's were codified into ASC Topic 820.

Applicability

This document applies to the valuation and related financial statement and investor reporting disclosures for all real estate investments under both the Operating and Non-operating reporting models described within the REIS standards. The fundamental premise for fair value accounting models is based on existing authoritative accounting standards, which require that investments be reported at fair value and as such, the provisions of FAS 157 are applicable. The accounting profession has used the authoritative guidance contained in the AICPA Audit and Accounting Guide, *Audits of Investment Companies* (IC Guide) to support the use of a fair value based model because many institutional real estate investment vehicles (e.g. open and closed-end commingled funds, pooled trusts and separate accounts) have attributes similar to an investment company as described in the IC Guide. In addition, FASB Accounting Standards Codification Topic 960, *Plan Accounting-Defined Benefit Pension Plans* (ASC Topic 960) (previously FAS 35, *Accounting and Reporting by Defined Benefit Pension Plans* and GAS 25, *Financial Reporting for Defined Pension Plans and Note Disclosures for Defined Contribution Plans*), require fair value reporting of investments. The Operating Model and the Non-operating model present financial information differently. Differing interpretations applied to debt valuation within the context of ASC Topic 820 have, in some cases, produced differing net asset values even when the economics of the underlying transaction are essentially similar.

The Valuation Standards contained in the REIS standards address the valuation of real property without regard to any encumbrance (i.e., the “free and clear value”). This document provides guidance with respect to the additional considerations in order to holistically value financial statements.

Using this Guidance Document

This document provides guidance for the implementation of ASC Topic 820, as part of compliance with the REIS standards which require quarterly valuation of all property investments, fair value accounting in accordance with GAAP and the election of FASB Accounting Standards Codification Topic 825, *Financial Instruments*, (ASC Topic 825) (previously FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, or FAS 159) for all notes payable liabilities.

This guidance is not a substitute for reading and understanding relevant professional literature, related entity governing documents, and transaction level documentation. Professional judgment must be exercised when considering various alternatives for valuation, accounting and disclosures.

The provisions of this guidance document need not be applied to immaterial items.

III. ACCOUNTING CONSIDERATIONS

This section outlines certain accounting considerations within the context of ASC Topic 820 that factor into the valuation of debt associated with real estate investments under the Operating and Non-operating reporting models.

Principles of Fair Value Measurements

The fundamental principles of fair value measurements include the following:

- Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (as defined in ASC Topic 820).
- The unit of account determines what is being measured by reference to the level at which the asset or liability is aggregated (disaggregated) for purposes of applying other accounting pronouncements. The unit of account for the asset or liability should be determined in accordance with the provisions of other accounting pronouncements (ASC Topic 820, Subtopic 10, Section 35).
- A fair value measurement assumes that the asset or liability is exchanged in an orderly transaction between market participants to sell the asset or transfer the liability at the measurement date. The transaction to sell the asset or transfer the liability is a hypothetical transaction at the measurement date, considered from the perspective of a market participant that holds the asset or owes the liability (ASC topic 820, Subtopic 10, Section 35). The exit price objective applies for all assets and liabilities measured at fair value.
- When multiple markets exist for an asset or liability, the fair value should be based on the principal market. If there is no principal market, the most advantageous market should be used as determined from the perspective of the reporting entity. The principal market is defined as the market in which the reporting entity would sell the asset or transfer the liability with the greatest volume and level of activity for the asset or liability. The most advantageous market is the market in which the reporting entity would sell the asset or transfer the liability with price that maximizes the amount that would be received for the asset or minimizes the amount that would be paid to transfer the liability (ASC Topic 820, Subtopic 10, Section 35).
- Fair value measurements of assets assumes the highest and best use by market participants, considering the use of the asset that is physically possible, legally permissible, and financially feasible at the measurement date. Fair value measurements of liabilities assumes that the liability is transferred to a market participant at the measurement date (the liability to the counterparty continues; it is not settled) and that the nonperformance risk relating to the liability is the same before and after its transfer.(ASC Topic 820, Subtopic 10, Section 35)
- Fair value measures should consider the utility of the asset or liability being measured and specific attributes to the asset or liability (ASC Topic 820, Subtopic 10, Section 35).
- Transaction costs should be excluded from all fair value measurements (ASC Topic 820, Subtopic 10, Section 35).

Open-end investment vehicles widely used in our industry trade directly on NAV. Closed-end investment vehicles trade at negotiated prices, which tend to be based on NAV therefore consistent application of valuation principles is of paramount importance.

Consistent Application of Fair Value Measurement Principles to Assets and Liabilities

As part of the deliberation process for FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, (which now represents non-authoritative guidance per Accounting Standards Codification Topic 105, Subtopic 10, Section 5-3) we note that the term entity-specific value was used to describe the value of an asset to its owner if the asset were held over its expected holding period rather than sold in a current transaction. Within the commercial real estate appraisal community, the concept of *entity-specific value* has long been referred to, and is synonymous with the term, *investment value*. Investment value is not the same as fair value as “entity-specific” measurements “substitutes the entity’s assumptions for those that market-place participants would make” (CON 7 paragraph 24(b)) as would be required under FAS 157.

As an example of the difference between investment value and fair value, assume the owners of an asset were granted a favorable real estate tax break on the asset which was contractually restricted from transfer. The fair value of the asset would be determined using a market rate assumption for the real estate tax rather than the reduced tax rate break. Accordingly, the fair value of the asset would be less than the value to the entity specific value, where, existing investor(s) continue to receive the benefit of the real estate tax break.

Unit of Account

When valuing real estate investments under ASC Topic 820, all industry participants use either:

- One unit of account- the net equity value of the invested dollar (Net Method).
- Two units of account- the real estate asset and related debt (Gross Method)

When implementing Topic 820, each unit of account is valued separately.

There are two reporting models in the real estate investment industry - the operating model and non-operating model. Users of each model generally view unit of account as follows:

- The non-operating reporting model uses the Investment Company presentation where the unit of account under ASC Topic 820 is generally interpreted as the net equity value of the underlying real estate investment (i.e., the line item "Investment in Real Estate" on the Statement of Net Assets).
- The operating reporting model uses an operating company presentation where the Statement of Net Assets show, as separate line items, the gross investment in real estate and the secured mortgage liability, each of which is generally considered a unit of account.

Practitioners (auditors and financial statement preparers) using either approach are mixed with regard to their determination of the unit of account, as defined in FAS 157, with some determining the unit of account based on the presentation model and others disregarding presentation and determining the unit of account based on either a purely net view or a purely gross view.

In Appendix 2, different valuation scenarios have been prepared, the corresponding accounting result under the different models and accounting position utilized are provided to illustrate the differences in the interpretation of the unit of account.

Market Participant Behavior

Background and Context of ASC Topic 820

ASC Topic 820 defines market participants as the buyers and sellers in the principal (or most advantageous) market for the asset or liability that are:

- a. Independent of the reporting entity; that is they are not related parties
- b. Knowledgeable, having a reasonable understanding about the asset or liability and the transaction based on all available information, including information that might be obtained through due diligence efforts that are usual and customary
- c. Able to transact for the asset or liability
- d. Willing to transact for the asset or liability; that is, they are motivated but not forced or otherwise compelled to do so.

ASC Topic 820 further states that fair value be determined based on the assumptions market participants would use in pricing the asset or liability.

From the perspective of the leveraged real estate equity investor, the primary relevance of valuing existing debt instruments relates to their impact on purchases and sales of real estate investments. Simply stated, loans that carry interest rates and other terms that are more favorable than those currently available in the marketplace for new debt increase the value of the collateralized property; those with less favorable terms reduce value.

ASC Topic 820, Subtopic 10, Section 35 provides that when determining the fair value measurement for an asset an assumption of the highest and best use of the asset by market participants must be made. In determining market participant assumptions regarding the highest and best use of an asset consideration must be given to uses of the asset that are physically possible, legally permissible, and financially feasible at the measurement date. In other words in determining the highest and best use of the asset consideration must be given to restrictions on that asset. The implementation guidance in ASC Topic 820, Subtopic 10, Section 35 provides examples regarding the impact of restrictions on determining the value of assets under ASC Topic 820. In general ASC Topic 820 concludes that even the existence of legal restrictions on the sale of an asset does not mean the reporting entity should assume the asset cannot be sold and thus has no fair value or a fair value equal to the reporting entity's cost, but rather, that restriction attribute should be considered in determining the fair value of the asset in a hypothetical sale of the asset.

Industry Applicability

The FASB establishes GAAP for the broad capital markets and not specifically for private market real estate investments. This necessitates interpretation which has resulted in the two divergent views on the application of ASC Topic 820's guidance to levered real estate investments - the gross view and the net view (described in more detail below).

Market Transaction Facts:

- Open-end fund units trade at net asset value with the fund on one side of the transaction.
- Closed-end fund units generally trade in secondary market transactions, without involving the fund.
- Venture level equity interests trade (in whole or in part) with liabilities as a pricing consideration
- Property level equity interests trade (in whole or in part) with liabilities as a pricing consideration
- Liabilities do not separately trade

Therefore, valuing liabilities will likely depend on unobservable inputs (level 3 within ASC Topic 820). Accordingly, in order to value the liability industry participants identify a market proxy. Below is a comparison of the two views perspective on market participant behavior. Differences in valuation considerations are described in Section IV below as well as in Appendix 6.

- Holders of the net view:
 - Apply a principles based implementation approach to ASC Topic 820-a principles based standard
 - Argue there is one unit of account
 - Believe the AICPA Audit and Accounting Guide – *Audits of Investment Companies* (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
- Holders of the gross view
 - Apply a rules based implementation approach to ASC Topic 820-a principles based standard
 - 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, *Measuring*

Liabilities at Fair Value (now included in ASC Topic 820, Subtopic 10, Sections 35, 55 & 65) drives the view of market participant behavior.

- 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

The two views can produce different NAVs even when facts and circumstances are substantially the same.

Guidance:

- A method once chosen should be consistently applied at each of the property, investment and fund levels.
- Methodologies, processes and assumptions should be disclosed.

Two views of market participant behavior are described below:

The Net View of Market Participant Behavior

The net view of market participant behavior focuses on specific application of ASC Topic 820 to private market real estate investments. Holders of the net view implement a principles based application of ASC Topic 820.

Those who have implemented the net view of market participant behavior believe that real estate investments (which when encumbered include debt) are assets (one unit of account as described above).

In the net view, threshold issues include whether or not the loan encumbrance is transferable/assumable and/or whether a prospective buyer would want to assume it. If the answer to either of the preceding questions is no, analysis continues with the basic assumption that the loan would be settled as part of a presumed transaction. Under ASC Topic 820, market participant assumptions are considered in the valuation of assets, that is if the market participant assumption will not benefit from an attribute because it is restricted or relates to the holder of the asset/liability, then the market participant will likely not attribute any significant value to the attribute. Therefore, if a loan which is collateralized by an asset is non-transferable it must be repaid upon sale of the collateralized property, and therefore differences in market interest rates on the loan do not impact on the value of the real property investment. In such a case, using the net view the fair value of the loan itself prior to the definitive decision to sell is likely to be the remaining principal balance. However, if the remaining principal balance of the loan is greater

than the fair value of the related property, the value of the net real estate investment may be zero unless guarantees and other similar obligations exist. If the loan carries a prepayment penalty or other costs to discharge prior to maturity, those costs are typically recognized at the time that the definitive decision to sell is made and are therefore excluded from the determination of fair value.

For an illustration of the Net View please see appendix 3.

The Gross View of Market Participant Behavior

Holders of the gross view believe that ASC Topic 820's guidance should be applied separately to the components of the Net Investment in Real Estate. This requires the determination of the fair value of the real estate asset (the property) separately from the fair value of the liability (separate units of account as described above). Under the gross view all debt is valued in a hypothetical transfer at the measurement date, regardless of contractual restrictions. The credit profile and financing terms in the hypothetical transfer are identical to the mortgage being measured at fair value and therefore contractual restrictions on transfer are not relevant.

Holders of the gross view cite Paragraph 15 of FAS 157 to support the position that the fair value of liabilities is determined based on the assumption that the liability is transferred to a market participant at the measurement date and the liability continues (it is not settled); and that the nonperformance risk of the liability is the same both before and after its transfer, requiring the consideration of the entity's own credit risk (credit standing) be reflected in the fair value measurement. Under this gross view the market participant assumptions regarding the determination of the value of the real estate asset (the property) are largely unchanged (see assumptions above), but that the value of the property has a direct impact on the creditworthiness of the entity holding the real estate that needs to be reflected in the fair value of the liability.

Under the gross view there are separate markets and market participants for real estate assets and debt encumbrances. Although liabilities (the obligation to make a stream of payments) are not transferred in the marketplace, the related asset (the right to receive a stream of payments) is often transferred. Holders of the gross view consider the entity's nonperformance risk when determining the price (fair value) of these assets and holders of the gross view believe that fair value measurements of liabilities must conceptually (and are required under ASC Topic 820) to include nonperformance risk and credit standing. Holders of the gross view believe that changes in credit standing and in market interest rates impact the valuation of liabilities and the relative positions of debt and equity holders in the capital stack and that the accounting related to fair value measurements of liabilities under this approach is reflective of the underlying economics.

The result in the gross view is that debt is rarely, if ever, carried at a fair market value equal to the remaining principal balance, as market conditions typically change from the date the debt was originally issued.

For an expanded discussion of the gross view please see appendix 4.

Summary

Market participant behavior with respect to the valuation of existing debt encumbrances is a combination of art and science, is ultimately subject to negotiation, and varies widely based on market conditions and differing designations of market proxies and market participant behaviors within the context of ASC Topic 820. The differences in these two views manifest themselves in the accounting results (as illustrated within this document) and provide different value determinations.

IV. VALUATION CONSIDERATIONS

Real Property

The Valuation Standards contained within the REIS standards provide guidance with respect to the valuation of equity real estate. Use of these standards is appropriate for ASC Topic 820 implementation.

Mortgages and Notes Receivable

Mortgages and Notes receivable are generally fair valued using the fixed income mathematics. ASC Topic 820 refers to such valuation techniques as the “income approach” (see ASC Topic 820 Subtopic 10 Section 35). An illustration of this valuation technique is provided in Appendix 5.

Mortgages and Notes Payable

Included as Appendix 6 is a summary of the valuation considerations for the gross and net views.

Encumbered Positions under the Gross View

Under the gross view, mortgages and notes payable are generally fair valued using the fixed income mathematics found within Appendix 5. Those who ascribe to the gross view of valuing notes payable perform credit analysis based on the right to receive a stream of cash flows, generally presume a “mirror-image” valuation between lender and borrower and conclude that the valuation process has been completed.

Encumbered Positions under the Net View

Background and Summary

Supporters of the net view, think the valuation of encumbered real estate investments requires a holistic approach to valuation so that the net equity position (i.e., the net real estate investment or invested dollar) is valued. Accordingly, the values derived from the valuation of mortgages and notes payable described within the preceding section would serve as an input to the valuation of the liability using a net view. Summarized below are some of the major considerations in estimating the impact of debt on the fair value of the equity interest.

Methodologies

Two basic methods for adjusting existing debt to market are generally accepted: leveraged equity analysis and cash equivalency analysis. In a leveraged equity analysis, the projected cash flow after debt service is analyzed and valued based upon current market leveraged yields to directly value a property subject to existing debt. The advantage of this approach is that it directly values the interest appraised, i.e., the leveraged cash flow after debt at contract terms. However, this method may not be used as a matter of practice due to the lack of reliable, current data on leveraged yields, and a high degree of variance to those leveraged yields in the market based upon such factors as loan-to-value ratio, remaining term, risk of the leveraged cash flow, and other factors. While these must be considered in any debt analysis, the lack of readily available current yield rates under various scenarios makes this approach essentially impractical. Over time, institutional investors might allow their leverage yield transactions to become more “transparent”, at which time this methodology may see increasing use in the market.

The more common method of adjusting existing debt to market is a cash equivalency adjustment, (discounted cash flows approach) which was described in detail above. The advantage of this methodology is that it utilizes parameters more readily available in the market, and directly measures the financial implications for a buyer, comparing the cost to assume existing debt versus acquiring new debt in the marketplace.

Although neither methodology can perfectly isolate the impact of debt in some market environments, utilizing an analysis which considers both methodologies helps to assess the impact of debt on the fair value of the invested dollar.

Major Considerations of Cash Equivalency

While cash equivalency is based upon a mathematical calculation, it is important to note that these calculations are made and analyzed in connection with an appraiser’s judgment as to their impact on fair value of the subject as encumbered by debt. While many situations may involve a direct calculation, others may involve other considerations which may temper the appraiser’s opinion of the impact of the existing debt. Some of these considerations are highlighted below.

Transferability

An important early consideration is the transferability of the debt. In determining the transferability of debt, not only must the cost to transfer the debt be considered, but also any terms and conditions of the transferability. While many loans do allow for transfers, are there requirements that the lender approve the borrower? If so, to what degree are the lender requirements for borrowers consistent with the typical buyer for the subject real estate? Would likely buyers for the subject (if unencumbered) likely not qualify for transfer approval? If limitations on transferability limit the potential buyers for the subject as encumbered, is there enough investment interest in the asset to attract qualified buyers without impacting the potential transfer price? Additionally, consideration must be given to “non-transferable” debt or loans where transfer rights are silent. It is important to keep in mind; however, that most “non-transferable” debt may be able to be transferred, particularly when it is at rates above current market levels.

Treatment of Loan Transfer Costs

Although debt transfer costs are considered when determining debt transferability, consistent with generally accepted appraisal procedures for other transaction costs (i.e., sales commissions, transfer taxes, etc.), transfer costs should not be directly calculated when making a cash equivalency adjustment.

Loan Prepayment Fees

Prepayment fees should generally not be deducted as an adjustment to the property as encumbered.

New Loan Fees

If a buyer purchases a property free and clear of debt, and placed new debt on the property, he would typically incur costs (e.g., due diligence and other transaction related costs) for that debt. Thus, if a buyer were to assume debt, he would save those costs. Typically the saved costs of new debt to a buyer assuming debt should be reflected in the calculations.

Market Debt Rate Determination

Generally, loans rates are quoted based upon a spread over current treasuries.

Treasury Term Utilized for Comparison

An important question is whether a comparison of contract debt should be made to market treasuries of the remaining term, original term, or typical market term. The advantage of the two latter choices is that it compares the subject's existing debt rate to a rate that a buyer would typically experience if encumbering the property with new debt. The disadvantage of utilizing either original term or typical term is that it compares a presumably shorter contract term with a longer market term, and compares unlike risk and stability factors. Remaining term is probably the most applicable comparison, however buyer exposure to rate change at maturity, particularly with shorter-term remaining debt, must be considered.

Risk of Prepayment Penalty

Although buyers may be willing to purchase debt-encumbered properties at cash equivalency or a percentage thereof, there is some risk that certain buyers for a property may not want the debt in place, requiring the seller to prepay the debt. The risk of this occurring is influenced by the variance between the cash equivalency and the prepayment fees, which are typically based upon a "make-whole" provision to treasury rates, often with a basis points spread. Generally, the risk of a buyer insisting on prepayment increases with shorter remaining terms, although this is partially due to the fact that prepayment is often more economically viable with shorter remaining terms.

Other Considerations to Conclusions

After making the mathematical calculations, some adjustments and/or reconciliations may need to be applied based upon various factors. Thus, there is at need for appraiser judgment, consistent with broader wholly-owned equity appraisal analysis.

Some of the factors an appraiser may consider in concluding a final value impact of encumbering debt on the value of the invested dollar include:

-
- Is the remaining term on the debt undesirable to a buyer? What is the general sense of the investment community regarding interest rate changes? How does this anticipation affect the buyer's perception as to his exposure at the end of the debt term? In general, most institutional investors are more willing to negotiate from a straight cash-equivalency calculation if the remaining term of the debt is shorter. However, this must be balanced with anticipated changes in the market from interest rate fluctuations, and more recently, from actual availability of debt.
 - Conversely, is the remaining term so short that it becomes less of a detriment to the leveraged position of the subject? Is the remaining term within a typical marketing time for the property type? Balancing the concept of market value as of a given date with the concept of avoiding a liquidation conclusion, would a seller hold an asset for the remainder of a short debt term rather than absorb a prepayment or cash equivalency penalty?
 - How far is the contract debt from current market levels? Is the difference so insignificant that, when considering their leveraged position, a buyer would not look negatively on the existing debt? Is there variation from contract to market material?
 - How desirable is the underlying property? Does the asset have significant enough investment appeal that a buyer may be willing to accept an above-market rate at an adjustment less than a mathematical adjustment calculation? In very desirable properties, a buyer may accept a lower percentage of a cash equivalency calculation based upon the desire to acquire the underlying property.
 - Is the likely buyer of the asset considering condominium conversion? If the underlying asset is being heavily influenced by a highest and best use involving condominium conversion, then the likely buyer cannot practically maintain debt, and may insist on prepayment. In situations where condominium conversion is possible and feasible, a weighting to the prepayment penalty may be appropriate. If the potential buyer is clearly a converter, the debt adjustment may be the full prepayment penalty.
 - Does the typical buyer for the subject usually apply leverage? Consideration must be given to whether buyers want leveraged ownership, even if adjusted to market terms. Typically, buyers who purchase on a wholly-owned equity basis prefer lower loan-to-value ratios (LTV) (coupled with shorter terms). However, buyers who typically acquire properties, placing new debt with maximum allowable LTVs, may find lower existing debt problematic, as it would require more creative financing to take the property debt to a maximum allowable LTV. Under some market conditions, creative financing is much more difficult, and any existing debt may be viewed more positively (relative to recent history), given the lack of availability of debt.

Summary of Considerations

A cash equivalency adjustment should be the primary methodology for estimating appropriate market value adjustments to properties encumbered by debt. The results of this calculation should be compared to the costs to prepay the debt, with a preliminary conclusion of the more positive (or less negative) impact on value.

The preliminary conclusion must be reconciled to a final conclusion, utilizing the appraisers' judgment, following consideration of market, property, and debt variables. The appraisers' judgment in assessing the desirability of the underlying property and existing debt must be utilized to determine the appropriate percentage of cash equivalency which would represent the current market environment.

Finally, the leveraged rate of return resulting from leveraged cash flows under existing debt should be analyzed in relation to the leveraged rate of return if the debt were at current market levels, prior to any reconciliation to the prepayment.

Fund level debt

If a fund elects the fair value option under ASC Topic 825 (as required under the REIS standards) and records fund level debt at fair value, the unit of account and unit of valuation are the separately identified debt instruments and therefore the change in fair value of the debt must consider current market interest rates, etc.

V. PERFORMANCE MEASUREMENT

In addition to the footnote disclosures relating to ASC Topic 820 which is required for GAAP reporting purposes (see Appendix 7) the task force recommends an expansion of performance attribution to measure the impact of leverage decisions on overall real estate returns. The following example isolates the valuation component of returns, consistent with the focus of the document.

With the implementation of ASC Topic 820 and the resulting impact to the Time Weighted Return (TWR) Appreciation/ (Depreciation) component, further disclosure is necessary to adequately explain the results. It is recommended that the effects of ASC Topic 820 be isolated and identified separately within the Appreciation/ (Depreciation) component of the TWR. Below is an example for both the Net and Gross TWR disclosure.

Time Weighted Return Disclosure –

<u>Gross Return</u>	<u>Financial</u> <u>Amount</u>	<u>Performance</u> <u>Return</u>
Unrealized Appr. /(Depr.) Real Estate Investment	\$1,500,000	1.50%
Realized Appr./ (Depr.) Real Estate Investment		
Unrealized Currency Gain/(Loss)		
Realized Currency Gain/(Loss)		
Unrealized Appr. /(Depr.) on Debt	250,000	0.25%
Realized Appr./ (Depr.) on Debt		
Incentive Fee/Carried Interest		
Total Appreciation/(Depreciation)	\$1,750,000	1.75%

<u>Net Return</u>	<u>Financial</u> <u>Amount</u>	<u>Performance</u> <u>Return</u>
Unrealized Appr. /(Depr.) Real Estate Investment	\$1,500,000	1.50%
Realized Appr./ (Depr.) Real Estate Investment		
Unrealized Currency Gain/(Loss)		
Realized Currency Gain/(Loss)		
Unrealized Appr. /(Depr.) on Debt	250,000	0.25%
Realized Appr./ (Depr.) on Debt		
Incentive Fee/Carried Interest	(100,000)	(0.10%)
Total Appreciation/(Depreciation)	\$1,650,000	1.65%

Guidance

- Performance attribution data resulting from implementing ASC Topic 820 should be isolated and identified separately within the appreciation/depreciation component of the return

**FASB ASC Topic 820, *Fair Value Measurements and Disclosures*:
Implementation Guidance for Real Estate Investments**
A REIS Guidance Document

September 1, 2009

APPENDICES

Appendix 1

Evolution of FASB ASC Topic 820

FSP FAS 157-1—Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13 (formerly FSP FAS 157-a, now included in ASC Topic 820)

Summary:

This FASB Staff Position (FSP) amends FASB Statement No. 157, Fair Value Measurements (now included in ASC Topic 820), to exclude FASB Statement No. 13, Accounting for Leases (now included in FASB Accounting Standards Codification Topic 840, *Leases*), and other accounting pronouncements that address fair value measurements for purposes of lease classification or measurement under Statement 13. However, this scope exception does not apply to assets acquired and liabilities assumed in a business combination that are required to be measured at fair value under FASB Statement No. 141, Business Combinations, (now included in FASB Accounting Standards Codification Topic 805, *Business Combinations*, or ASC Topic 805) or No. 141 (revised 2007), Business Combinations (now also included in ASC Topic 805), regardless of whether those assets and liabilities are related to leases.

FSP FAS 157-2—Effective Date of FASB Statement No. 157 (formerly FSP FAS 157-b, now included as ASC Topic 820, Subtopic 10, Sections 15, 50 & 55)

Summary:

This FASB Staff Position (FSP) delays the effective date of FASB Statement No. 157, Fair Value Measurements (now included in ASC Topic 820), for nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). The delay is intended to allow the Board and constituents additional time to consider the effect of various implementation issues that have arisen, or that may arise, from the application of Statement 157.

FSP FAS 157-3—Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active (formerly FSP FAS 157-d, now included in ASC Topic 820, Subtopic 10, Sections 35 & 65)

Summary:

This FASB Staff Position (FSP) clarifies the application of FASB Statement No. 157, Fair Value Measurements (now included in ASC Topic 820), in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active.

FSP FAS 157-4—Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly (formerly FSP FAS 157-e, now included in ASC Topic 820, Subtopic 10, Section 65)

Summary:

This FASB Staff Position (FSP) provides additional guidance for estimating fair value in accordance with FASB Statement No. 157, *Fair Value Measurements* (now included in ASC Topic 820), when the volume and level of activity for the asset or liability have significantly decreased. This FSP also includes guidance on identifying circumstances that indicate a transaction is not orderly.

ASU 2009-5, Measuring Liabilities at Fair Value (formerly FSP FAS 157-c & f, now included in ASC Topic 820, Subtopic 10, Sections 35, 55 & 65)**Summary:**

This Accounting Standards Update (ASU) amends ASC Topic 820 by providing additional guidance clarifying the measurement of liabilities at fair value. Among other things, the guidance clarifies how the price of a traded debt security (i.e., an asset value) should be considered in estimating the fair value of the issuer's liability. ASU 2009-05 is effective for the first reporting period (including interim periods) beginning after its issuance (e.g., the quarter ended December 31, 2009 for a calendar-year entity); with early application permitted if financial statements have not been issued. ASC Topic 820 concludes that even the existence of legal restrictions on the sale of an asset does not mean the reporting entity should assume the asset cannot be sold and thus has no fair value or a fair value equal to the reporting entity's cost, but rather, that restriction attribute should be considered in determining the fair value of the asset in a hypothetical sale of the asset.

Exposure Draft: FSP FAS 157-g, Applying fair value to interests in alternative investments. (To provide application guidance related to ASC Topic 820)**Summary:**

The objective of this project is to address the application of FASB Statement No. 157, *Fair Value Measurements* (now included in ASC Topic 820), to interests in alternative investments, such as hedge funds and private equity funds.

Status:

Comments were due to the FASB by July 8, 2009 and this project is currently in redeliberations.

Appendix 2

Valuation and Accounting Examples

The following examples present illustrations of hypothetical debt encumbrances on real estate assets, and conclude their impact under the net view, followed by differences (if any) under the gross view.

SAMPLE VALUATION OF DEBT - FAVORABLE FINANCING

The subject real estate encumbered by the debt is a Class A, 220,000 square foot office building located in Anytown, USA, built in 1981. The property is currently 94.4% occupied.

The following bullet points summarize the existing debt on the subject property:

Original Loan Date:	January-06
Loan Maturity Date:	February-16
Earliest Prepayment Date:	February-16
Remaining Term:	7.2 years
Original Balance:	\$19,000,000
Remaining Balance:	\$19,000,000
Interest Rate:	5.32%
Repayment Terms:	Interest only through maturity
Transferable:	Yes

MARKET DEBT CONCLUSION

A market rate of approximately 410 – 470 basis points over comparable-term treasuries is appropriate as of the valuation date, considering the subject’s class. Based upon an estimated equivalent-term treasury yield of 1.80% (estimated based upon a range of similar-terms yields), the current market debt rate for the property would typically be 5.90% to 6.50%. However, given the current estimated 7.5% “floor” from most lenders for longer-term fixed rate debt, we conclude a market rate of 7.50%. We estimate the cost to place new debt on the property to be 1.0% of the loan balance.

CASH EQUIVALENCY CALCULATION

The following chart presents our cash equivalency adjustment calculations. We have added to the cash equivalency calculation the costs of a new loan only for substantially above-market debt, as the assumption of existing debt would save the buyer incurring this expense, which would lessen the negative impact of above-market debt. We have not, however, added these savings to already positive cash equivalency adjustments. We have assumed that if the current loan were replaced, it would be interest-only for the remaining term.

Cash Equivalency Summary			
Total Debt			\$19,000,000
Present Value of Payments			\$5,590,600
Present Value of Balloon			\$11,118,515
Cash Equivalency Difference			2,290,885
Plus Origination Fee			\$0
Less Loan Assumption Fee			Not Calculated
Cash Equivalency Adjustment			\$2,290,885

ESTIMATED PRE-PAYMENT COSTS

Based upon the loan documents, the owner can prepay the existing debt based upon a prepayment fee of the greater of 1.0% of the remaining loan balance, or a yield maintenance requirement tied to similarly-maturing treasuries. Based upon the formula, we calculate the prepayment penalty, utilizing a current yield on the treasury of 1.80%, to be \$3,803,049, which is greater than the 1% calculation of \$190,000.

PRELIMINARY CONCLUSION

As a preliminary conclusion, we have compared the estimated cost to the seller to adjust the wholly owned equity value based upon cash equivalency to the cost to prepay the loan. This comparison is presented below.

Debt Adjustment Calculation			
Cash Equivalency Adjustment			\$2,290,885
Loan Prepayment Adjustment			-\$3,803,049
Most Positive Scenario			Cash Equivalency
Debt Adjustment			\$2,290,885

As indicated, because of below-market financing, the impact of the existing debt is a positive \$2,290,885, while the cost is \$3,803,049 to pre-pay the debt. Thus, the seller of a property would typically not pre-pay the loan and incur a penalty, but would sell the property based upon a much lower cash equivalency cost.

ADDITIONAL CONSIDERATIONS

We have also considered some of the subjective issues regarding the subject and its existing loan. The following table summarizes the overall desirability of the subject and debt as it relates to the cash equivalency calculation.

Primary Adjustment Considerations			
Property Type	Office - Class A	Positive	
Age/Class	1981	Positive	
Remaining Term (Years)	7.2	Positive	
Variation to Debt (Basis Points)	-218	Neutral	
Loan-to-Value (Implied)	21%	Slightly Negative	
Overall		Positive	

Typically, we conclude that a buyer would likely accept something less than a full cash equivalency adjustment for desirable properties with unfavorable debt with a general broad market range of 40% to 100% of full negative cash equivalency. For favorable debt on desirable quality assets, we generally estimate 80% to 100% of cash equivalency, but with no additional credit for the cost to place new capital. The positive conclusion is based upon the desirability of in-place debt in today's capital-restricted market.

In the case of the subject, we estimate that the market would accept 90% of full cash equivalency as an adjustment for subject debt.

The calculations are shown below.

Debt Adjustment Conclusion			
Calculated Debt Adjustment		\$2,290,885	
Market Adjustment Range		40% - 100%	
Estimated Market Adjustment		90%	
Indicated Debt Adjustment		2,061,797	
Rounded		\$2,100,000	

LEVERAGED EQUITY ANALYSIS AS A TEST OF REASONABLENESS

As a test of reasonableness, we have utilized a leveraged equity analysis to estimate the leveraged internal rate of return which would be generated by the underlying leveraged real estate. In order to establish the basis of the equity contribution, we have applied a discount rate of 8.50% and a terminal capitalization rate of 7.50% to the projected unencumbered cash flows as provided to us by the client. In utilizing these cash flows and investment parameters to estimate the implied leveraged IRR, we reiterate that we are not estimating the market value of the unencumbered subject real estate, as this is outside the scope of this assignment. We are utilizing the estimate only as a basis of equity contribution for the purpose of presenting an implied leverage IRR.

The following table presents the calculation of the implied leveraged internal rate of return.

Leveraged Equity Analysis			
Sample Property			
	Implied Unencumbered Value		\$92,000,000
	Adjustment to Value for Debt		\$2,100,000
	Less Mortgage Balance		\$19,000,000
	Implied Equity Contribution		\$75,100,000
	Cash Flow Available for		Cashflow
<u>Year</u>	<u>Debt Service and Income Taxes</u>	<u>Debt Service</u>	<u>After Debt Service</u>
1	\$4,738,877	\$1,010,800	\$3,728,077
2	\$4,564,806	\$1,010,800	\$3,554,006
3	\$6,527,408	\$1,010,800	\$5,516,608
4	\$5,986,714	\$1,010,800	\$4,975,914
5	\$6,901,728	\$1,010,800	\$5,890,928
6	\$6,599,364	\$1,010,800	\$5,588,564
7	\$6,640,114	\$1,010,800	\$5,629,314
8	\$7,078,219	\$19,168,467	-\$12,090,248
9	\$7,006,864	\$0	\$7,006,864
10	\$7,559,294	\$0	\$7,559,294
	Implied Total Reversion		\$117,384,139
	Less Mortgage Balance at Reversion		\$0
	Equity Proceeds from Reversion		\$117,384,139
	Indicated Leveraged IRR		8.9%

As demonstrated, the above analysis indicates that, based upon an equity contribution influenced by not only the existing debt, but our estimate of the impact of that debt on market value, a buyer of the subject would achieve a leveraged return of 8.9% over the holding period.

The following chart calculates the leveraged return, assuming the same debt were placed on the property at current market rates, interest only for the short remaining term.

Leveraged Equity Analysis - At Market			
Sample Property			
	Implied Unencumbered Value		\$92,000,000
	Adjustment to Value for Debt		\$0
	Less Mortgage Balance		\$19,000,000
	Implied Equity Contribution		\$73,000,000
	Cash Flow		
	Available for		Cashflow
	Debt Service and	Debt	After
<u>Year</u>	<u>Income Taxes</u>	<u>Service</u>	<u>Debt Service</u>
1	\$4,738,877	\$1,425,000	\$3,313,877
2	\$4,564,806	\$1,425,000	\$3,139,806
3	\$6,527,408	\$1,425,000	\$5,102,408
4	\$5,986,714	\$1,425,000	\$4,561,714
5	\$6,901,728	\$1,425,000	\$5,476,728
6	\$6,599,364	\$1,425,000	\$5,174,364
7	\$6,640,114	\$1,425,000	\$5,215,114
8	\$7,078,219	\$19,237,500	-\$12,159,281
9	\$7,006,864	\$0	\$7,006,864
10	\$7,559,294	\$0	\$7,559,294
	Implied Total Reversion		\$117,384,139
	Less Mortgage Balance at Reversion		\$0
	Equity Proceeds from Reversion		\$117,384,139
	Indicated Leveraged IRR		8.9%

As indicated, a purchaser who would acquire the subject with existing debt based upon our modified cash equivalency adjustment would achieve a greater leveraged IRR than if acquired on an unleveraged basis, and the adjustment produces an IRR near that which would be achieved if the property were leveraged at market terms. This is consistent with our research which demonstrates that buyers are willing to accept favorable debt if the underlying real estate asset is desirable and the purchase price is appropriately adjusted to provide a reasonable leveraged return. Accepting the subject debt provides a greater return on a leveraged basis, which some survey participants indicated was an offsetting factor to accepting the debt. The following chart summarizes the implied IRRs based upon the three scenarios.

Summary of Implied IRRs	
Unleveraged Implied IRR	8.5%
Leveraged IRR with Existing Debt	8.9%
Leveraged IRR with Market Debt	8.9%

Therefore, based upon the cash equivalency analysis, and supported by the leverage equity analysis, the adjustment for debt, also supported by our research and data, appears to be reasonable.

CONCLUSION

Based upon the previous analysis, we estimate the market value impact of the existing encumbering debt on the subject, after rounding, as of December 31, 2008, to be:

TWO MILLION ONE HUNDRED THOUSAND DOLLARS
\$2,100,000

Accounting considerations:

Consideration should be given to the form of the investment and the accounting method adopted by the reporting entity.

Non-operating model considerations

In this instance given the debt is assumable, a market participant would likely attribute value to favorable debt financing. Therefore regardless of whether the reporting entity has a controlling or a non-controlling interest in the investment, the debt should be recorded at the fair value adjustment or \$2,100,000 as noted above. This would result in the following accounting entry:

Dr Investment in XYZ	\$2,100,000	
Cr Unrealized gain on investment in XYZ		\$2,100,000

Operating model considerations

As noted above, regardless of control, when the debt is at favorable terms and assumable, then the debt should be recorded at fair value. For the operating model the unit of valuation follows the unit of account and therefore the following entry would be recorded:

Dr Mortgage Loan Payable	\$2,100,000	
Cr Unrealized gain on revaluation of debt		\$2,100,000

As noted above in instances where the debt is assumable, there is likely no difference in accounting between the operating and the non-operating model.

Impact of debt that cannot be transferred

Non-operating model considerations

In this instance given the debt is not assumable, consideration should be given as to whether the investment is controlled by the investor. That is can the acquirer of the investment (as an ASC Topic 820 fair value is an exit value) benefit from the below market debt and therefore would a market participant attribute value to the below market debt.

Controlling interest

In instances where the investor controls the investment and has the investment structured in a single LLC structure, the sale of the real estate would likely dissolve the entity and therefore require repayment of the below market debt. In this scenario the fair value of the debt maybe equal to par.

Non-controlling interest

In instances where the investor holds a non-controlling interest in the investment, (i.e. an LP interest), the sale of the investment could occur without the debt being required to be repaid. In this scenario a market participant would likely allocate fair value to the below market nature of the debt as the ultimate cash flows to be received would differ from an equal investment with at market debt.

Operating model considerations

Under the operating model, an investor consolidates an investment that it controls. In such situation the asset and debt is shown gross on the balance sheet. Consideration should be given to whether it is appropriate to value the asset and debt together as one unit of valuation or separately. If the asset and debt are valued separately, the fair value of debt that cannot be transferred is unlikely to be par. If the asset and debt are valued together, fair value of the debt could be par such that when the fair value is allocated between the asset and liability for presentation on the balance sheet all the change in fair value is allocated to the asset.

As noted above in instances where the debt is not assumable, there is likely a difference in accounting between the operating and the non-operating model.

SAMPLE VALUATION OF DEBT - UNFAVORABLE FINANCING

We now utilize the same hypothetical property, but assume it is encumbered by unfavorable financing.

The following bullet points summarize the existing debt on the subject property:

Original Loan Date:	January-06
Loan Maturity Date:	February-16
Earliest Prepayment Date:	February-16
Remaining Term:	7.2 years
Original Balance:	\$19,000,000
Remaining Balance:	\$19,000,000
Interest Rate:	8.97%
Repayment Terms:	Interest only through maturity
Transferable:	Yes

MARKET DEBT CONCLUSION

A market rate of approximately 410 – 470 basis points over comparable-term treasuries is appropriate as of the valuation date, considering the subject’s class. Based upon an estimated equivalent-term treasury yield of 1.80% (estimated based upon a range of similar-terms yields), the current market debt rate for the property would typically be 5.90% to 6.50%. However, given the current estimated 7.5% “floor” from most lenders for longer-term fixed rate debt, we conclude a market rate of 7.50%. We estimate the cost to place new debt on the property to be 1.0% of the loan balance.

CASH EQUIVALENCY CALCULATION

The following chart presents our cash equivalency adjustment calculations. We have added to the cash equivalency calculation the costs of a new loan only for substantially above-market debt, as the assumption of existing debt would save the buyer incurring this expense, which would lessen the negative impact of above-market debt. We have not, however, added these savings to positive cash equivalency adjustments. We have assumed that if the current loan were replaced, it would be interest-only for the remaining term.

Cash Equivalency Summary			
Total Debt			\$19,000,000
Present Value of Payments			\$9,426,257
Present Value of Balloon			\$11,118,515
Cash Equivalency Difference			-1,544,771
Plus Origination Fee			\$190,000
Less Loan Assumption Fee			Not Calculated
Cash Equivalency Adjustment			-\$1,354,771

ESTIMATED PRE-PAYMENT COSTS

Based upon the loan documents, the owner can prepay the existing debt based upon a prepayment fee of the greater of 1.0% of the remaining loan balance, or a yield maintenance requirement tied to similarly-maturing treasuries. Based upon the formula, we calculate the prepayment penalty, utilizing a current yield on the treasury of 1.80%, to be \$8,382,853, which is greater than the 1% calculation of \$190,000.

PRELIMINARY CONCLUSION

As a preliminary conclusion, we have compared the estimated cost to the seller to adjust the wholly owned equity value based upon cash equivalency to the cost to prepay the loan. This comparison is presented below.

Debt Adjustment Calculation			
Cash Equivalency Adjustment			-\$1,354,771
Loan Prepayment Adjustment			-\$8,382,853
Most Positive Scenario			Cash Equivalency
Debt Adjustment			-\$1,354,771

As indicated, because of above-market financing, the impact of the existing debt is a negative \$1,354,771, while the cost is \$8,382,853 to pre-pay the debt. Thus, the seller of a property would typically not pre-pay the loan and incur a penalty, but would sell the property based upon a much lower cash equivalency cost.

ADDITIONAL CONSIDERATIONS

We have also considered some of the subjective issues regarding the subject and its existing loan. The following table summarizes the overall desirability of the subject and debt as it relates to the cash equivalency calculation.

Primary Adjustment Considerations			
Property Type	Office - Class A	Positive	
Age/Class	1981	Positive	
Remaining Term (Years)	7.2	Positive	
Variation to Debt (Basis Points)	147	Neutral	
Loan-to-Value (Implied)	21%	Slightly Negative	
Overall		Positive	

Typically, we conclude that a buyer would likely accept something less than a full cash equivalency adjustment for desirable properties with unfavorable debt with a general broad market range of 40% to 100% of full negative cash equivalency. For favorable debt on desirable quality assets, we generally estimate 80% to 100% of cash equivalency, but with no additional credit for the cost to place new capital. The positive conclusion is based upon the desirability of in-place debt in today's capital-restricted market.

In the case of the subject, given the general lack of availability of financing in today's market, we estimate that the market would accept 60% of full cash equivalency as an adjustment for subject debt.

The calculations are shown below.

Debt Adjustment Conclusion			
Calculated Debt Adjustment			-\$1,354,771
Market Adjustment Range			40% - 100%
Estimated Market Adjustment			60%
Indicated Debt Adjustment			-812,863
Rounded			-\$800,000

LEVERAGED EQUITY ANALYSIS AS A TEST OF REASONABLENESS

As a test of reasonableness, we have utilized a leveraged equity analysis to estimate the leveraged internal rate of return which would be generated by the underlying leveraged real estate. In order to establish the basis of the equity contribution, we have applied a discount rate of 8.50% and a terminal capitalization rate of 7.50% to the projected unencumbered cash flows as provided to us by the client. In utilizing these cash flows and investment parameters to estimate the implied leveraged IRR, we reiterate that we are not estimating the market value of the unencumbered subject real estate, as this is outside the scope of this assignment. We are utilizing the estimate only as a basis of equity contribution for the purpose of presenting an implied leverage IRR.

The following table presents the calculation of the implied leveraged internal rate of return.

Leveraged Equity Analysis			
Sample Property			
	Implied Unencumbered Value		\$92,000,000
	Adjustment to Value for Debt		-\$800,000
	Less Mortgage Balance		\$19,000,000
	Implied Equity Contribution		\$72,200,000
	Cash Flow Available for		Cashflow
<u>Year</u>	<u>Debt Service and Income Taxes</u>	<u>Debt Service</u>	<u>After Debt Service</u>
1	\$4,738,877	\$1,704,300	\$3,034,577
2	\$4,564,806	\$1,704,300	\$2,860,506
3	\$6,527,408	\$1,704,300	\$4,823,108
4	\$5,986,714	\$1,704,300	\$4,282,414
5	\$6,901,728	\$1,704,300	\$5,197,428
6	\$6,599,364	\$1,704,300	\$4,895,064
7	\$6,640,114	\$1,704,300	\$4,935,814
8	\$7,078,219	\$19,284,050	-\$12,205,831
9	\$7,006,864	\$0	\$7,006,864
10	\$7,559,294	\$0	\$7,559,294
	Implied Total Reversion		\$117,384,139
	Less Mortgage Balance at Reversion		\$0
	Equity Proceeds from Reversion		\$117,384,139
	Indicated Leveraged IRR		8.7%

As demonstrated, the above analysis indicates that, based upon an equity contribution influenced by not only the existing debt, but our estimate of the impact of that debt on market value, a buyer of the subject would achieve a leveraged return of 8.7% over the holding period.

The following chart calculates the leveraged return, assuming the same debt were placed on the property at current market rates, interest only for the short remaining term.

Leveraged Equity Analysis - At Market			
Sample Property			
	Implied Unencumbered Value		\$92,000,000
	Adjustment to Value for Debt		\$0
	Less Mortgage Balance		\$19,000,000
	Implied Equity Contribution		\$73,000,000
	Cash Flow Available for		Cashflow
<u>Year</u>	<u>Debt Service and Income Taxes</u>	<u>Debt Service</u>	<u>After Debt Service</u>
1	\$4,738,877	\$1,425,000	\$3,313,877
2	\$4,564,806	\$1,425,000	\$3,139,806
3	\$6,527,408	\$1,425,000	\$5,102,408
4	\$5,986,714	\$1,425,000	\$4,561,714
5	\$6,901,728	\$1,425,000	\$5,476,728
6	\$6,599,364	\$1,425,000	\$5,174,364
7	\$6,640,114	\$1,425,000	\$5,215,114
8	\$7,078,219	\$19,237,500	-\$12,159,281
9	\$7,006,864	\$0	\$7,006,864
10	\$7,559,294	\$0	\$7,559,294
	Implied Total Reversion		\$117,384,139
	Less Mortgage Balance at Reversion		\$0
	Equity Proceeds from Reversion		\$117,384,139
	Indicated Leveraged IRR		8.9%

As indicated, a purchaser who would acquire the subject with existing debt based upon our modified cash equivalency adjustment would achieve a greater leveraged IRR than if acquired on an unleveraged basis, and the adjustment produces an IRR near that which would be achieved if the property were leveraged at market terms, given the difficulty in achieving market rate debt in today's environment. This is consistent with our research which demonstrates that buyers are willing to accept favorable debt if the underlying real estate asset is desirable and the purchase price is appropriately adjusted to provide a reasonable leveraged return. Accepting the subject debt provides a greater return on a leveraged basis, which some survey participants indicated was an offsetting factor to accepting the debt. The following chart summarizes the implied IRRs based upon the three scenarios.

Summary of Implied IRRs	
Unleveraged Implied IRR	8.5%
Leveraged IRR with Existing Debt	8.7%
Leveraged IRR with Market Debt	8.9%

Therefore, based upon the cash equivalency analysis, and supported by the leverage equity analysis, the adjustment for debt, also supported by our research and data, appears to be reasonable.

CONCLUSION

Based upon the previous analysis, we estimate the market value impact of the existing encumbering debt on the subject, after rounding, as of December 31, 2008, to be:

NEGATIVE EIGHT HUNDRED THOUSAND DOLLARS
-\$800,000

Accounting considerations:

Consideration should be given to the form of the investment and the accounting method adopted by the reporting entity.

Non-operating model considerations

In this instance given the debt is assumable, a market participant would likely attribute value to favorable debt financing. Therefore regardless of whether the reporting entity has a controlling or a non-controlling interest in the investment, the debt should be recorded at the fair value adjustment of \$800,000 as noted above. This would result in the following accounting entry:

Dr Unrealized loss on investment in XYZ	\$800,000	
Cr Investment in XYZ		\$800,000

Operating model considerations

As noted above, regardless of control, when the debt is at favorable terms and assumable, then the debt should be recorded at fair value. For the operating model the unit of valuation follows the unit of account and therefore the following entry would be recorded:

Dr Unrealized loss on investment in XYZ	\$800,000	
Cr Mortgage loan payable		\$800,000

As noted above in instances where the debt is assumable, there is likely no difference in accounting between the operating and the non-operating model.

Impact of debt that cannot be transferred

Non-operating model and operating model considerations

Considerations for determining fair value are the same as with below market debt. Refer to the discussion above.

As noted above in instances where the debt is not assumable, there is likely a difference in accounting between the operating and the non-operating model.

SAMPLE VALUATION OF DEBT - NEAR MARKET FINANCING

We now utilize the same hypothetical property, but assume it is encumbered by financing at near-market terms.

The following bullet points summarize the existing debt on the subject property:

Original Loan Date:	January-06
Loan Maturity Date:	February-16
Earliest Prepayment Date:	February-16
Remaining Term:	7.2 years
Original Balance:	\$19,000,000
Remaining Balance:	\$19,000,000
Interest Rate:	7.75%
Repayment Terms:	Interest only through maturity
Transferable:	Yes

MARKET DEBT CONCLUSION

A market rate of approximately 410 – 470 basis points over comparable-term treasuries is appropriate as of the valuation date, considering the subject’s class. Based upon an estimated equivalent-term treasury yield of 1.80% (estimated based upon a range of similar-terms yields), the current market debt rate for the property would typically be 5.90% to 6.50%. However, given the current estimated 7.5% “floor” from most lenders for longer-term fixed rate debt, we conclude a market rate of 7.50%. We estimate the cost to place new debt on the property to be 1.0% of the loan balance.

CASH EQUIVALENCY CALCULATION

The following chart presents our cash equivalency adjustment calculations. We have added to the cash equivalency calculation the costs of a new loan only for substantially above-market debt, as the assumption of existing debt would save the buyer incurring this expense, which would lessen the negative impact of above-market debt. We have not, however, added these savings to 100% positive cash equivalency adjustments. We have assumed that if the current loan were replaced, it would be interest-only for the remaining term.

Cash Equivalency Summary			
Total Debt			\$19,000,000
Present Value of Payments			\$8,144,202
Present Value of Balloon			\$11,118,515
Cash Equivalency Difference			-262,716
Plus Origination Fee			\$190,000
Less Loan Assumption Fee			Not Calculated
Cash Equivalency Adjustment			-\$72,716

ESTIMATED PRE-PAYMENT COSTS

Based upon the loan documents, the owner can prepay the existing debt based upon a prepayment fee of the greater of 1.0% of the remaining loan balance, or a yield maintenance requirement tied to similarly-maturing treasuries. Based upon the formula, we calculate the prepayment penalty, utilizing a current yield on the treasury of 1.80%, to be \$6,852,069, which is greater than the 1% calculation of \$190,000.

PRELIMINARY CONCLUSION

As a preliminary conclusion, we have compared the estimated cost to the seller to adjust the wholly owned equity value based upon cash equivalency to the cost to prepay the loan. This comparison is presented below.

Debt Adjustment Calculation			
Cash Equivalency Adjustment			-\$72,716
Loan Prepayment Adjustment			-\$6,852,069
Most Positive Scenario			Cash Equivalency
Debt Adjustment			-\$72,716

As indicated, because of near-market financing, the impact of the existing debt is a negative \$72,716, while the cost is \$6,852,069 to pre-pay the debt. Thus, the seller of a property would typically not pre-pay the loan and incur a penalty, but would sell the property based upon a much lower cash equivalency cost.

ADDITIONAL CONSIDERATIONS

We have also considered some of the subjective issues regarding the subject and its existing loan. The following table summarizes the overall desirability of the subject and debt as it relates to the cash equivalency calculation.

Primary Adjustment Considerations			
Property Type	Office - Class A	Positive	
Age/Class	1981	Positive	
Remaining Term (Years)	7.2	Positive	
Variation to Debt (Basis Points)	25	Neutral	
Loan-to-Value (Implied)	21%	Slightly Negative	
Overall		Positive	

Typically, we conclude that a buyer would likely accept something less than a full cash equivalency adjustment for desirable properties with unfavorable debt with a general broad market range of 40% to 100% of full negative cash equivalency. For favorable debt on desirable quality assets, we generally estimate 80% to 100% of cash equivalency, but with no additional credit for the cost to place new capital. The positive conclusion is based upon the desirability of in-place debt in today's capital-restricted market.

In the case of the subject, we estimate that the market would accept 60% of full cash equivalency as an adjustment for subject debt.

The calculations are shown below.

Debt Adjustment Conclusion			
Calculated Debt Adjustment			-\$72,716
Market Adjustment Range			40% - 100%
Estimated Market Adjustment			60%
Indicated Debt Adjustment			-43,630
Rounded			\$0

LEVERAGED EQUITY ANALYSIS AS A TEST OF REASONABLENESS

As a test of reasonableness, we have utilized a leveraged equity analysis to estimate the leveraged internal rate of return which would be generated by the underlying leveraged real estate. In order to establish the basis of the equity contribution, we have applied a discount rate of 8.50% and a terminal capitalization rate of 7.50% to the projected unencumbered cash flows as provided to us by the client. In utilizing these cash flows and investment parameters to estimate the implied leveraged IRR, we reiterate that we are not estimating the market value of the unencumbered subject real estate, as this is outside the scope of this assignment. We are utilizing the estimate only as a basis of equity contribution for the purpose of presenting an implied leverage IRR.

The following table presents the calculation of the implied leveraged internal rate of return.

Leveraged Equity Analysis			
Sample Property			
	Implied Unencumbered Value		\$92,000,000
	Adjustment to Value for Debt		\$0
	Less Mortgage Balance		\$19,000,000
	Implied Equity Contribution		\$73,000,000
	Cash Flow Available for		Cashflow
<u>Year</u>	<u>Debt Service and Income Taxes</u>	<u>Debt Service</u>	<u>After Debt Service</u>
1	\$4,738,877	\$1,472,500	\$3,266,377
2	\$4,564,806	\$1,472,500	\$3,092,306
3	\$6,527,408	\$1,472,500	\$5,054,908
4	\$5,986,714	\$1,472,500	\$4,514,214
5	\$6,901,728	\$1,472,500	\$5,429,228
6	\$6,599,364	\$1,472,500	\$5,126,864
7	\$6,640,114	\$1,472,500	\$5,167,614
8	\$7,078,219	\$19,245,417	-\$12,167,198
9	\$7,006,864	\$0	\$7,006,864
10	\$7,559,294	\$0	\$7,559,294
	Implied Total Reversion		\$117,384,139
	Less Mortgage Balance at Reversion		\$0
	Equity Proceeds from Reversion		\$117,384,139
	Indicated Leveraged IRR		8.8%

As demonstrated, the above analysis indicates that, based upon an equity contribution influenced by not only the existing debt, but our estimate of the impact of that debt on market value (in this case zero), a buyer of the subject would achieve a leveraged return of 8.8% over the holding period.

The following chart calculates the leveraged return, assuming the same debt were placed on the property at current market rates, interest only for the short remaining term.

Leveraged Equity Analysis - At Market			
Sample Property			
	Implied Unencumbered Value		\$92,000,000
	Adjustment to Value for Debt		\$0
	Less Mortgage Balance		\$19,000,000
	Implied Equity Contribution		\$73,000,000
	Cash Flow Available for		Cashflow
<u>Year</u>	<u>Debt Service and Income Taxes</u>	<u>Debt Service</u>	<u>After Debt Service</u>
1	\$4,738,877	\$1,425,000	\$3,313,877
2	\$4,564,806	\$1,425,000	\$3,139,806
3	\$6,527,408	\$1,425,000	\$5,102,408
4	\$5,986,714	\$1,425,000	\$4,561,714
5	\$6,901,728	\$1,425,000	\$5,476,728
6	\$6,599,364	\$1,425,000	\$5,174,364
7	\$6,640,114	\$1,425,000	\$5,215,114
8	\$7,078,219	\$19,237,500	-\$12,159,281
9	\$7,006,864	\$0	\$7,006,864
10	\$7,559,294	\$0	\$7,559,294
	Implied Total Reversion		\$117,384,139
	Less Mortgage Balance at Reversion		\$0
	Equity Proceeds from Reversion		\$117,384,139
	Indicated Leveraged IRR		8.9%

As indicated, a purchaser who would acquire the subject with existing debt based upon our modified cash equivalency adjustment would achieve a greater leveraged IRR than if acquired on an unleveraged basis, and the adjustment produces an IRR near that which would be achieved if the property were leveraged at market terms. This is consistent with our research which demonstrates that buyers are willing to accept favorable debt if the underlying real estate asset is desirable and the purchase price is appropriately adjusted to provide a reasonable leveraged return. Accepting the subject debt provides a greater return on a leveraged basis, which some survey participants indicated was an offsetting factor to accepting the debt. The following chart summarizes the implied IRRs based upon the three scenarios.

Summary of Implied IRRs	
Unleveraged Implied IRR	8.5%
Leveraged IRR with Existing Debt	8.8%
Leveraged IRR with Market Debt	8.9%

Therefore, based upon the cash equivalency analysis, and supported by the leverage equity analysis, the adjustment for debt, also supported by our research and data, appears to be reasonable.

CONCLUSION

Based upon the previous analysis, we estimate the market value impact of the existing encumbering debt on the subject, which is near market terms, after rounding, as of December 31, 2008, to be:

ZERO
\$0

Accounting considerations:

As noted above in instances where the debt is assumable, there is likely no difference in accounting between the operating and the non-operating model. If the debt is not transferrable refer to considerations in previous two examples.

SAMPLE VALUATION OF DEBT - REMAINING BALANCE EXCEEDS COLLATERAL ASSET VALUE

In situations where the remaining balance of the debt exceeds the market value of the underlying asset, or the collateral to the debt, the debt would typically be non-transferable from a market perspective. If the debt is unfavorable and exceeding a 100% LTV ratio, there would likely be no market to transfer the property with the encumbered debt. Even if the debt were otherwise favorable, a lender would typically not allow the transfer of the debt if it exceeds the collateral value. Thus, if the debt were for practical purposes non-transferable, the impact of the encumbrance is zero, and the debt would be carried at par, or the remaining balance.

As in many situations in valuing the impact of the debt encumbrance, this conclusion could vary under certain circumstances. If in fact the lender expressed willingness to allow a transfer, and the circumstances of the property indicate a transfer is plausible, the debt could have some impact. For example, if the loan documents indicate that a portion of the debt could be transferred (say up to a certain LTV), and it is believed that this would be a possible scenario, then that portion of the debt could be analyzed for impact. Under this scenario, the debt, or a portion thereof, could be analyzed utilizing a similar methodology to the samples above.

Accounting considerations:

Consideration should be given to the form of the investment and the accounting method adopted by the reporting entity.

Non-operating model considerations

Under the non-operating model, whether the entity controls the investment or not, the unit of valuation is the equity in the investment. If the lender was to foreclose on the property and the reporting entity has no additional liabilities related to the investment the fair value of the debt would be equal to the value of the property. Enterprise value is equal to zero.

Operating model considerations

Under the operating model where the reporting entity consolidates the asset and liability, the unit of valuation is the same as the unit of account, being the separate assets and liabilities of the investments. Therefore in this instance the assets and liabilities would be required to be fair valued separately and the reporting entity could be required to record a fair value of the liability that is different to the fair value of the asset. However in saying this given the debt is recourse only to the asset, and the asset value is less than the par value of the debt, a market participant would likely attribute a very a high spread or discount rate to the debt which could result in a fair value of the debt close to that of the asset.

In a situation where the reporting entity holds a non-controlling interest in the investment, the valuation of the debt would be consistent with that of the non-operating model.

Appendix 3

Market Participant Behavior-Net Method

Under the net view, the fundamental question asked by a market participant when valuing an existing debt instrument is, “How will the assumption of this loan impact the projected return on my investment relative to obtaining a new loan at current market terms?” As illustrated below, this question is answered quantitatively by comparing rates of return under multiple financing scenarios and discounting cash flows back to net present value. In practice:

- The purchaser will seek to negotiate a price that does not reflect the full economic benefit of a better-than-market loan, and the seller will seek to negotiate a price that does reflect the full economic benefit of the better than market loan.
- The seller will seek to negotiate a price that does not reflect the full economic detriment of a loan with terms that are less advantageous than those currently available in the market and the purchaser will seek to negotiate a price that does reflect the full economic detriment of a loan with terms that are less advantageous than those currently available in the market.

Market participant behavior will vary widely based on market conditions. In periods when debt financing is plentiful, interest rates are low, and property values are increasing, transferable debt has marginal relevance. Conversely, in periods when debt financing is scarce, interest rates/credit spreads are high or increasing, and terms of new debt are onerous, the existence of a transferable loan may make the difference between whether or not a transaction occurs. However, due to unavailability of debt in the marketplace during such periods, the quantitative aspects of the evaluation may become far less precise and more difficult to separate from the distressed pricing of the property itself.

Example - Acquisition A

➤ ***Property Description:***

- Class A office tower located in a Southwest CBD
- Purchase Price: \$114,500,000

➤ ***Loan Characteristics:***

- Principal Balance: \$80,800,000
- Above-market interest rate
- High prepayment penalty

- Assumable
- Fixed Interest Rate
- Interest Only Payments
- Non-recourse subject to typical carve outs

Debt Terms	Market	Existing Loan
LTV:	75% (Maximum)	71%
DSCR:	1.0-1.2X	1.1X
Fees:	.5% - .75%	.5% Transfer plus Legal & Application Fee
Term:	5 years	3 years when assumed
Interest Rate:	5.5%	5.84%

➤ **Summary:**

- The purchaser's willingness to assume the existing debt was key factor in being selected by the seller.
- Estimated \$6.2 million (5.2%) discount for assuming debt with above market interest rate.

Example - Acquisition B

➤ **Property Description:**

- Class B office building located in a Northeast CBD

➤ **Debt Characteristics:**

- Above-market interest rate
- High prepayment penalty
- Assumable

Debt Terms	Market (Fall 2006)	Existing Loan
LTV:	75% (Maximum)	70%
DSCR:	1.2X	1.2X
Remaining Term (Extension/Transferable):	3 years + 1 + 1	2 years + 1 + 1
Amortization:	Interest Only	Interest Only
Fees:	1.0%	1.0% Transfer + Legal / App Fee
Base Rate: (Fixed / Floating):	Floating	Floating
Spread:	250-275 bps	295 bps + increase for extension
All-In Rate:	4.5% - 4.75%	4.92%
Prepayment:	> Of 1% or Yield maintenance	Defeasance
Recourse:	None	None

➤ **Summary:**

- Off-market transaction in which the seller was only interested in a buyer willing to assume existing debt.
- Estimated discount of \$1,150,000 (5.0%) due to above market interest rate.

Disposition A

➤ **Description:**

- Class B office building located in Northeast suburb
- 82% leased at acquisition
- Value-Added investment

Terms	Market Terms (Spring 2008)	Assumed Terms
LTV:	65% (Maximum)	50%
DSCR:	1.25X	1.0 – 1.5X
Remaining Term (Extension / Transferable):	5 years	2 years
Amortization:	25 years	NA
Fees:	1.0%	1.0%
Base Rate: (Fixed / Floating)	Fixed	Fixed
Spread:	350 bps	NA
All-In Rate:	6.0-6.25%	5.45%
Prepayment:	> Of 1% or Yield Maintenance	> Of 1% or Yield Maintenance
Recourse:	15-25%	None

➤ **Summary:**

- Seller sought purchaser that would assume existing debt to avoid onerous prepayment penalty.
- Estimated \$2,250,000 (7.5%) premium paid by buyer to assume debt.

Appendix 4

Expanded Discussion of Gross View of Market Participant Behavior

As market benchmark interest rates increase relative to where the entity's existing debt was priced, creditors generally have recognized a loss in value on their investment and equity investors have gained in relative position with respect to the entity's cash flows. This relative gain (and accounting gain, when debt is marked-to-market) is effectively earned by the entity each period as a result of having below market interest rates. Holders of the "gross view" believe these gains accrue to the equity investor in the real estate investment and are in essence realized each time an interest payment is made by the entity.

Under the gross view, reporting entity's gains from the write-down of debt ("gains") are likely to be largely offset by the preceding "mark-to-market" losses recognized on the write-down of the asset; the result is the net equity in the entity is likely to be largely unaffected (or at least provided some offset). To the extent the financial distress of the asset held by the entity is of such a magnitude the potential exists for the value of the equity in the entity to approach or reach zero.

Fundamental to the "gross view" is the premise that the cash flows to the entity that holds the real estate are unchanged irrespective of the use of leverage (debt) or equity financing, but that the required rates of returns by the different claimants on these cash flows may be impacted in different manners when the value of the asset changes and general macroeconomic market conditions change (i.e. market interest rates, credit sector spreads, etc.). Under the "gross view" changes in market benchmark interest rates, credit sector spreads and entity specific credit spreads impact both the value of the debt and equity positions in the entity's capital stack. For example as market benchmark interest rates increase relative to where the entity's existing debt was priced, creditors generally have recognized a loss in value on their investment and equity investors have gained in relative position with respect to the entity's cash flows. This relative gain (and accounting gain, when debt is marked-to-market) is effectively earned by the entity each period as a result of having below market interest rates. Holders of the "gross view" believe these gains accrue to the equity investor in the real estate investment and are in essence realized each time an interest payment is made by the entity.

The difference is more dramatic when changes in entity specific credit risks are considered. In general as the value of the asset declines (due to market conditions impacting the fair value of the asset including, but not limited to, supply and demand, location, macroeconomic conditions, tenant mix, population growth, income growth, etc.), holders of the gross approach believe there is likely to be a direct impact on the entity's specific credit risk that must be reflected in the fair value of the debt encumbrance (liability), thereby, impacting the value of the equity investment in the entity. Ultimately, the application of ASC Topic 820's guidance, leads to unfamiliar results to the reporting entity under this approach; as credit spreads widen, debt is written down to fair value, resulting in gains, but such results need to be considered in totality.

This latter, gross approach provides results that some think are reflective of actual market pricing and theory. For example, in times of financial distress, finance theory holds that the cost of debt capital increases, meaning the rate of return required by market participants in the debt capital markets increases. The increased cost of debt, economically, results in a write-down of the value of the debt, as demonstrated through a discounted cash flow valuation approach. The “write-down” of the debt, which results in a book value gain (NAV gain), may or may not be perfectly offset by the loss in book value due to the “write-down” of the asset value. The fact that the asset and liability write-downs do not perfectly offset has theoretical underpinnings in corporate finance and capital structure theories. This lack of perfect offset can be explained by the fact that the rate of return required by potential market purchasers of the asset would reflect a weighted average cost of capital that would include debt and equity cost based on current market conditions, as most purchasers would finance the acquisition of real estate assets with a combination of debt and equity. In other words, the discount rate for a debt instrument is different than that of an asset, since a given asset will have claims by both debt and equity components, all else being equal. The end result is a fair value measurement of both the debt and equity that reflects the change in relative value of both the creditor’s and equity investor’s claims on the entity’s (the property’s) assets and underlying cash flows.

Appendix 5

Valuation of Mortgages and Notes Receivable and Payable Using the Income Approach

Background and Summary

This appendix summarizes the approach for the valuation of mortgages and notes receivable and payable in context with ASC Topic 820, examines key factors affecting valuations, and summarizes fixed income concepts that make up a discounted cash flow valuation model for debt. Those that follow the gross view to valuation of liabilities would likely conclude that the valuation process described herein provides a reasonable estimate of the fair value of liabilities (both secured and unsecured) to be reported within the fair value financial statements.

Debt Valuation Methodology

According to Brealy and Meyers in their **Principles of Corporate Finance**², the valuation of debt is simple – “you [just] take the cash flows and discount them at the opportunity cost of capital” (669). (This is sometimes also called the “cash equivalency method”.) While conceptually this may be simple, determination of the discount rate(s) can be quite challenging and subjective. The opportunity cost of capital from the Brealy-Meyers definition can be broken down into a market component and a credit spread component. One valuation approach is to model the contractual cash flows and the market interest rates, adjusted by the credit spread component, in order to determine the present value of all cash flows, the sum of which makes up the fair value.

There are two main elements that go into the fair value of debt – the contractual cash flows, and a risk adjusted discount curve. Conceptually, the fair value of the debt is the present value of those contractual cash flows, discounted at the current market cost of debt. Another way of considering the current cost of debt is to determine the interest rate that this debt could be replaced (or transferred) today given current market conditions and performance of the collateral (for secured debt).

Figure 1 below shows the different components of debt valuation and how they are used to determine the contractual cash flows and the discount curve.

¹ Brealy, Richard A. and Stewart C. Meyers. **Principals of Corporate Finance**. 6th ed. 2000, McGraw-Hill. Chapter 23 – Valuing Debt.

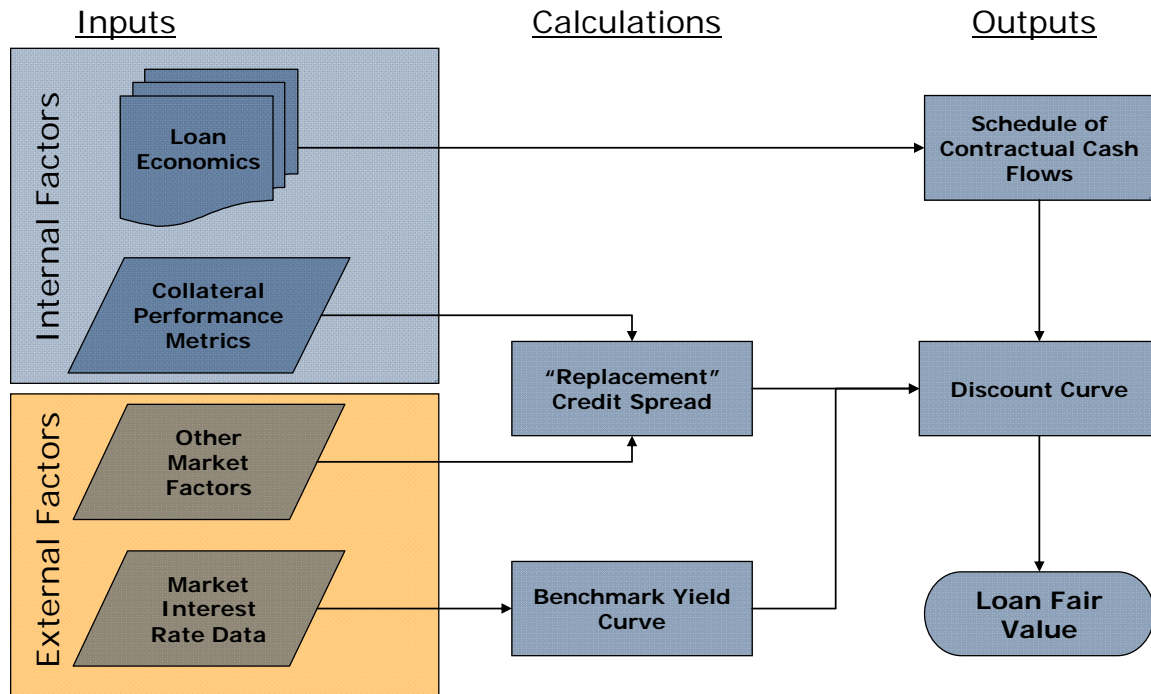


Figure 1

As shown by the two shaded areas on the left, the fair value of a debt instrument depends on both internal and external inputs. Internal inputs include all of the contractual information as defined in the loan agreements or other key documents. They also include the performance of the collateral and sometimes the parent company, if there are guarantees. External factors are partially market driven, such as the market interest rates and other market conditions, including the risk premiums required by market participants; and partially subjective, such as credit spreads for a given entity when debt for that entity is not actively traded or credit data is not readily available.

Internal Factors

Loan Economics

The loan documents (normally the mortgage loan agreement and promissory notes) should contain all of the key economic data that define the future cash flows for the loan. Specifically, information required to model the cash flows include:

Fixed Rate Loans – start date, maturity date, fixed rate coupon, payment frequency, payment dates, principal amount and any amortization information.

Floating Rate Loans – same as above, with the addition of the floating rate index and borrowing spread.

Collateral Performance

When lenders originate a loan, they critically evaluate the credit of the borrower to determine an appropriate credit charge. This evaluation usually includes information such as loan to value, expected debt service coverage, expected lease-up rates and

anything that would build the lender's confidence in the borrower's ability to make payments and ultimately repay the loan.

Once the loan is in place, the same factors must be considered in determining the current credit spread. If the property value has appreciated greatly, or the rented percentage of the underlying property is significantly higher than at origination, the current credit spread should be lower than at inception, all else held constant.

While it is not feasible to do a full appraisal of a property for every fair value calculation, general assumptions and information about the property or other underlying collateral (if the debt is secured) must be considered in estimating the replacement credit spread.

External Factors

Market Interest Rate Data – the Benchmark Yield Curve

The market interest rate data is normally based on a benchmark interest rate curve. This benchmark curve is usually made up of treasuries rates or swap rates and is the curve from which credit spreads are measured. This data is generally considered to be a Level 2 input under ASC Topic 820's fair value hierarchy.

In an active interest rate market, bonds and swaps are trading throughout the business day. The yields on these trades make up a "term structure of interest rates" which defines where the market demands yields for bonds at different maturities and equal credit levels.

The benchmark yield curve is used to generate two curves that are critical in fixed income mathematics. These are the implied forward curve and the discount curve. These curves are generated using a "bootstrapping" process that is described in detail in any fixed income mathematics text³. (Fabozzi, 121)

Discount Curve

The discount curve shows the present value, on a percentage basis, of future cash flows for any point in the future. This incorporates the full shape of the yield curve, meaning there is a different "yield" for each point in the future. While it is a common approximation to look at the maturity of a loan and interpolate treasury (or swap) yields to determine a discount rate, the only way to precisely discount all future cash flows is with a full, term-structure determined, discount curve. Figure 2 below shows the discount curve based on USD Swap rates with no adjustment for credit.

³ Fabozzi, Frank J. **Fixed Income Mathematics**. 4th Ed. 2006, McGraw-Hill. Chapter 8 – The Yield Curve, Spot Rate and Forward Rates.

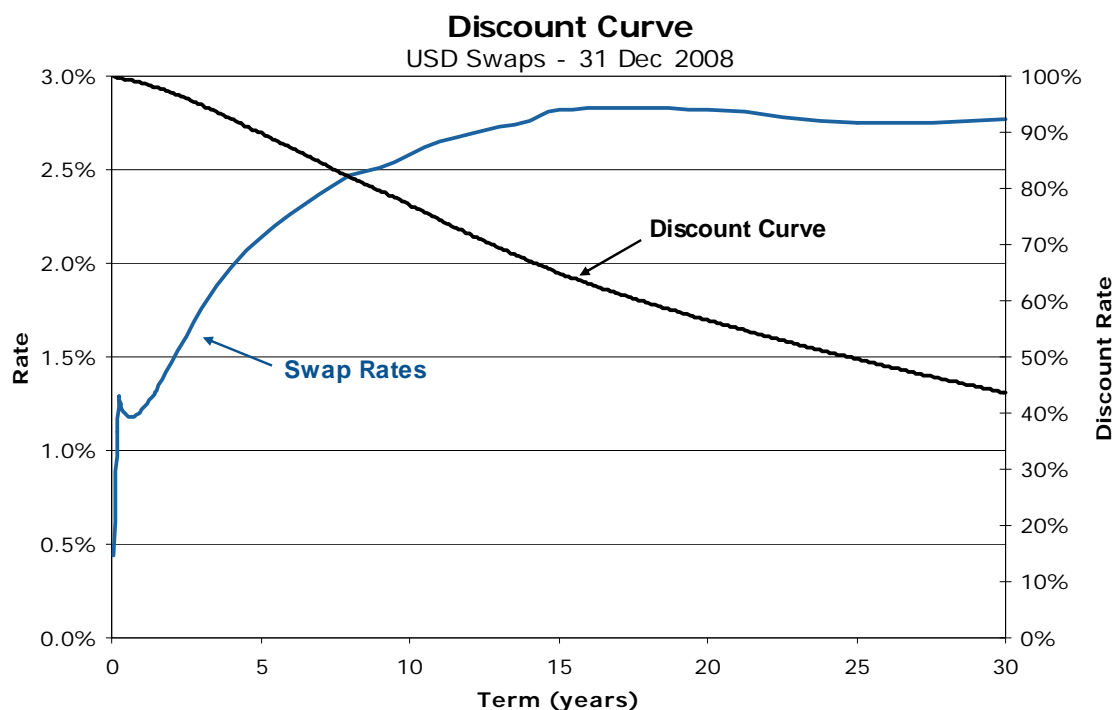


Figure 2

Implied Forward Curve

With discount rates varying based on the time to maturity, they can be used to calculate “implied forward” rates of any length (like 1 month LIBOR). For debt valuations, these are only a factor in determining the expected cash flows for floating rate loans. The term structure (through the discount curve) implies where all of the future rate settings will be for the loan. Figure 3 below shows the yield curve and implied 1 month LIBOR forward rates as of year- end 2008. Because the yield curve (“swap rates” on the graph) is analogous to a cumulative average (or term yield) of these forward rates, any slight change in the slope of the yield curve creates wide swings in the forward rates to move that cumulative average. This is why the implied forward rates are significantly higher than the swap rates (because the curve is upward sloping) and why the implied forward curve is not as smooth as the swap curve.

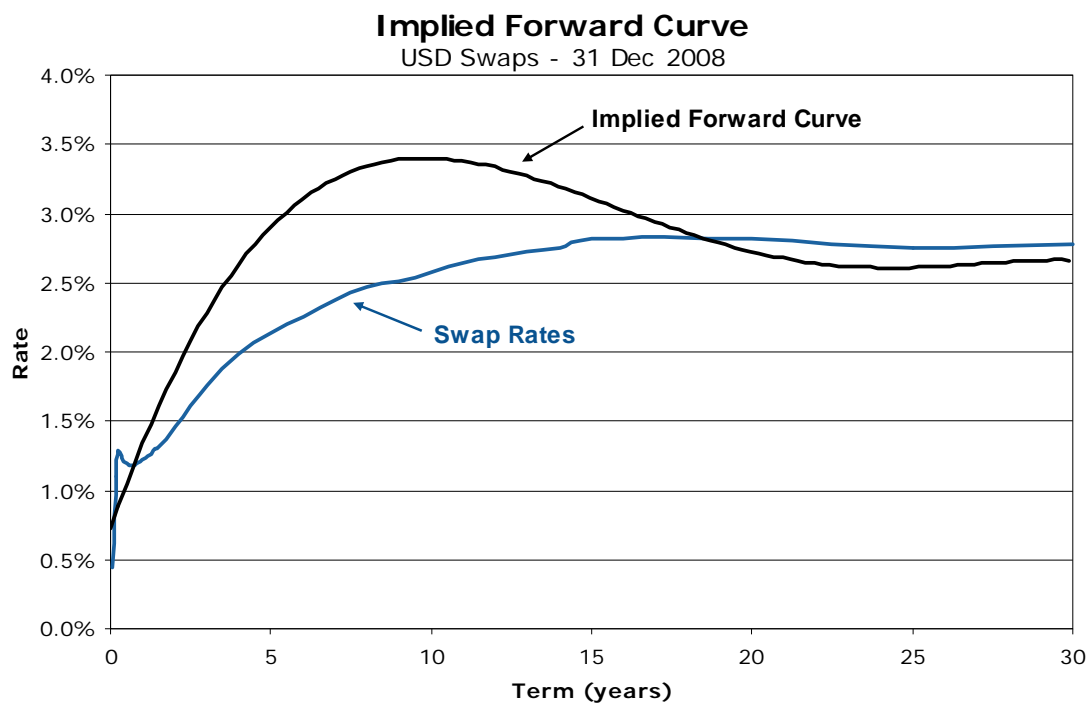


Figure 3

Of course, no one knows where interest rates will be in the future. The forward rates are where the market *implies* that rate to be today. They are also and where you could lock in that rate using interest rate derivatives or futures contracts.

Once the implied forwards and discount rates are calculated, the rest of the debt valuation is only a matter of using the discount factors to present value the contractual cash flows.

Other Market Factors

While the interest rate markets are impacted by many different factors, they don't necessarily capture other market factors that could more directly impact the credit worthiness of a specific property or other collateral. For example, different market factors may drive down hotel occupancy rates. This would likely have a negative impact on credit spreads in the hotel segment that would not be captured by the yield curve alone. Considering a real estate property as the collateral for a loan, a thorough evaluation of the market, the region, the asset type and any other factors that could impact the ability to borrow against that asset must be considered in determining the current credit spread to use for fair value calculations.

Replacement Credit Spread

As discussed above in the Collateral Performance section, the replacement credit spread is effectively the spread over the benchmark curve where a lender would replace the debt given today's market and the performance of the collateral. The credit spread is used to adjust the discount factors to accurately reflect the borrower's current credit risk.

Ideally, there is also a term-structure of credit, with different credit spreads for all different maturities. However, that is not always realistic and a single credit spread is used and the benchmark curve is adjusted in parallel across all maturities. Since the replacement credit spread for a loan should take into account the remaining term, the parallel shock should be an accurate application of the credit risk. Given the often subjective and unobservable nature of credit spreads, these inputs are generally considered Level 3 inputs under ASC Topic 820's fair value hierarchy.

Factors affecting Credit Spreads

Here are some factors to consider when estimating a credit spread:

- Consideration of the original borrowing spread on the debt to be valued – this is a good starting point
- Adjustment from the original spread for the changes in the following factors:
 - General market conditions
 - Credit sector spreads
 - Entity-specific credit spreads
 - Time remaining to maturity
 - Collateral or other credit enhancements (e.g., parent guarantees)
 - Any other factors
- Consideration of recent debt issuances and upcoming issuances

Key question asked: at what credit spread would this entity borrow for the remaining term of the instrument?

Example

For example, consider a 15 year fixed rate term loan originated 5 years ago. Assume the lender evaluates the credit risk and sets the fixed rate at 100 basis points over the 15 year treasury rate. At origination this is the market credit spread, since the lender just made that market for that particular loan-collateral package.

Now it is five years later. What is a reasonable adjustment from the 100 basis points assessed at origination?

- General market conditions have changed significantly, and there is a significant credit crunch in all markets. (*increase in credit spread*)
- The collateral for the loan was a large housing project, and the housing market is in much worse shape than it was at inception. (*increase in credit spread*)
- Despite the terrible housing market, this particular property has 5 years of strong performance and appears to be holding up in the difficult market. (*decrease in credit spread*)
- The loan now only has 10 years remaining – the shorter maturity means less credit exposure. (*typically a decrease in credit spread*)
- No change in collateral or credit enhancements (*no impact on credit spread*)
- The overall market for debt is small, creating a lack of liquidity. (*increase in credit spread – liquidity premium*)

Considering all of these factors, clearly the credit spread today will be higher than the original 100. Quantifying that difference is still a challenge. A common practice is to ask lenders, mortgage brokers, and the current lender how they would lend in the current market (if they would lend at all). Considering different maturities, LTV, regions, some lenders could give indicative ranges for current spreads. Then, all of the factors above are applied to increase/decrease those spreads to make the assumption more specific to the individual loan.

To continue the example, assume that, weighing all of these factors, the current credit spread is 425 bps over the original spread or 525 over treasuries. Figure 4 below shows the impact of a 350 basis point credit spread on the discount curve.

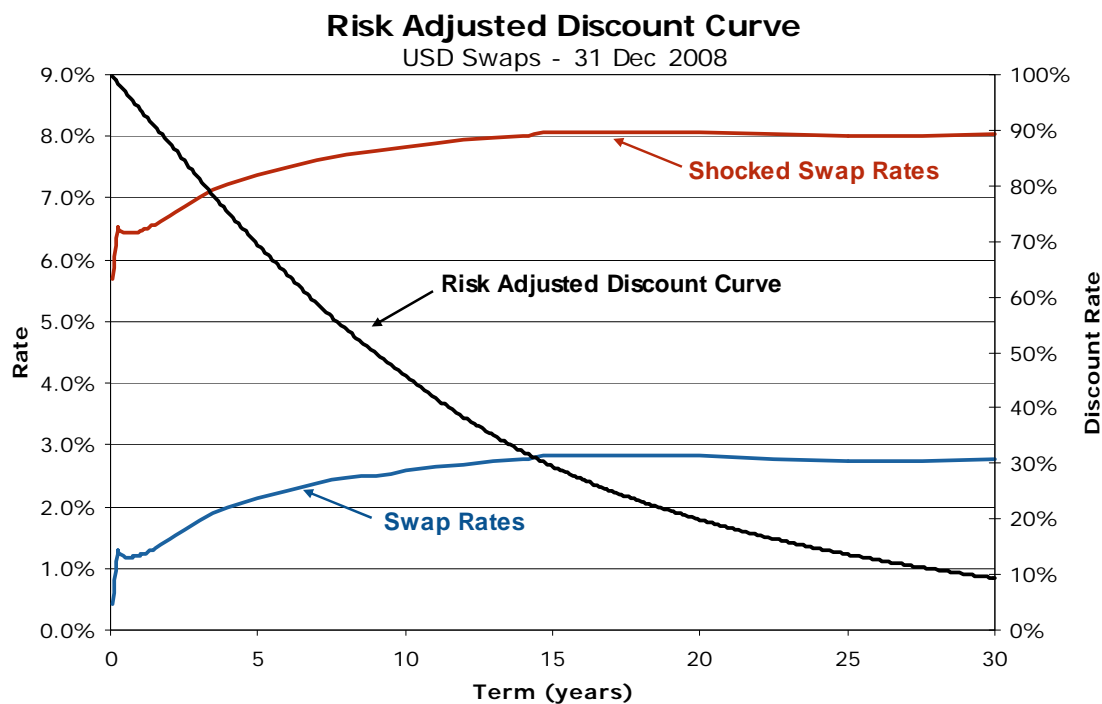


Figure 4

Notice that with the addition of the credit spread, the value of a payment 30 years from now has gone from a present value around \$0.44 to only \$0.09. Of course, the further out the payment, the larger the impact of the credit adjustment is on the discount factor and therefore the present value.

Schedule of Contractual Cash Flows

Fixed Rate Debt

For most fixed rate debt, the schedule of contractual cash flows is known at origination. Any amortization or accretion of the principal balances must be considered as part of the valuation.

Floating Rate Debt

Contractual cash flows for floating rate debt are more difficult to estimate at a given point in time, since the future rate resets are not yet known. This is what the implied forward curve described earlier is used for.

Please note - the replacement credit spread is NOT factored into the implied forward rates. Instead, the contractual borrowing spread is added to each implied forward rate for all future payments, forecasting out the future payments of the loan.

Debt/Loan Fair value

Fixed Rate Debt

With the risk adjusted discount curve created from the benchmark yield curve plus the current credit spread, all of the contractual cash flows for the fixed rate loan can be discounted back to the valuation date. Each individual payment is discounted based on the discount rate that corresponds to each payment date on the loan. The fair value is then the sum of those present valued payments.

Floating Rate Debt

In the past, it has not been uncommon for people to assume their floating rate debt to be valued at the remaining principal balance. This is because effectively, with every new floating reset, the debt is re-priced to the current market. This assumption, however, also assumes that there has been no change in the credit worthiness of the borrower and the real estate asset. Whenever there is a significant difference between the borrowing spread and current credit spreads, floating rate debt will no longer value at its remaining principal balance. If the spread on the loan is significantly lower than current credit spreads for that borrower, the debt would be valued at a discount, or smaller liability to the borrower, since there is real value to having a below market interest rate. Similarly, with a borrowing spread well above current credit spreads, the debt will value at a premium, or a larger liability to the borrower, since they are paying more than the market demands.

Effective Market Rate

The valuation methodology described in this section does not use any single rate to discount the payments. Rather, it uses the entire term structure to discount the payments, each with a discount factor appropriate for the timing of the payment. However, an effective market rate, or yield, for the loan is the single discount rate that, if used to discount all payments would result in the same present value as the actual discount curve. Similar to swap rates, the present value of each individual payment will not be the same, but the total value will match the total present value with the curve.

Appendix 6

Summary of Valuation Considerations

We present in this addendum several examples which demonstrate fair value analyses and conclusions for the impact of debt encumbrances. These examples are for illustrative purposes only, and are not intended to be prescriptive guidance as to appropriate market rates and or adjustments, as these conclusions and considerations can change over time as real estate and capital markets evolve.

In each of the following examples, we present the analysis first from the net view, with a methodology of valuing the net asset value position, or the invested dollar. Second, we present the conclusion from the perspective of separating the valuation of the debt from the asset, or what is referred to as the gross view. The appropriate view could vary based upon the unit of account considerations described within this document.

In general, many of the factors and considerations are identical for the two views, but some differences do potentially exist. In the net view, the analysis strives for a fair value conclusion which is appropriate for the net asset value position. Therefore, strong consideration is given to the relationship between the debt and the unencumbered asset, with consideration and potential adjustments (often subjective, but based upon market evidence) in how market participants would analyze the impact of the debt on the transfer of the net asset. Depending upon market conditions, the nature of the debt and capital markets, and the nature of the real estate, the final conclusion may, or may not, be a direct cash equivalency calculation of the variance between market and contract debt terms. Under the net view, leveraged equity analysis is often utilized as a test of reasonableness to conclude any adjustments needed to determine the fair value impact.

With the gross view, many of the same considerations are analyzed, but this view largely separates the debt from the asset for separate analysis. While the underlying asset collateral characteristics may be considered, its considerations are generally limited to establishing appropriate market debt rates, as opposed to the net view which considers the collateral as integral to understanding the net invested dollar. In general, the gross view analyzes the debt from a view of what a buyer would pay for the debt, and thus a straight cash equivalency is the primary valuation methodology. Adjustments for considerations of the debt on the net asset position are typically not made with the gross view, and a leveraged equity analysis would not be utilized.

The table on the following page presents many of the primary factors utilized in the two views, and highlights the differences which may occur in analyzing debt under each view.

	Net View	Gross View
Unit of Account	Net Asset Value; Debt is analyzed as a component to the net asset	Debt; Debt is largely separated from the encumbered asset
Likely Buyer	Buyer of the net asset	Buyer of the note
Impact of the Collateralized Real Estate	A key consideration in estimating the impact of the debt on the net asset position. Overall desirability of the asset impacts the perception of the buyer of the net asset position.	Considered primarily as a factor in establishing the market debt rate.
Loan-to-Value	Considered both from the perspective of establishing the market debt rate and the LTV's impact on the perception of likely buyers of the net asset. Higher LTVs generally indicate higher market debt rates, but higher LTV may be preferred by likely buyers of the encumbered real estate.	Considered primarily as a factor in establishing the market debt rate. Higher LTVs generally indicate higher market debt rates.
Remaining Term	Potentially impacts the market debt spread and treasury rate, and therefore the market debt rate. Also, consideration is given to the likely buyer's perceived risk of refinancing following the remaining term, if applicable to the likely buyer.	Potentially impacts the market debt spread and treasury rate, and therefore the market debt rate.
Likely Buyer for the Real Estate	Does the likely buyer of the real estate typically desire to leverage the asset, or is the likely buyer willing or likely to accept the debt. Is the likely buyer able to take the debt	Typically not a consideration.
Credit Quality of the Existing Borrower	Not a consideration, as the sale of the net asset is analyzed.	A key consideration, as the transfer of the obligation is assumed.
Transferability of the Debt	Non-transferable debt is generally considered to have no incremental impact	Non-transferability is not a factor in analyzing the debt.

	(i.e., is at par) since it cannot be transferred and therefore cannot impact the transfer of the net leveraged asset.	
Prepayment Penalties	Not directly calculated	Not directly calculated
Primary Valuation Methodology	Cash equivalency, but often with some subjective but supported adjustments when market evidence from leveraged transactions indicates the market behavior for buyers and sellers of leveraged real estate assets. A leveraged equity analysis is utilized as a test of reasonableness to analyze the implied leveraged returns to the likely buyer of the net asset position.	Cash equivalency

Appendix 7 SAMPLE FINANCIAL STATEMENT DISCLOSURES

Non-operating model

3. FAIR VALUE MEASUREMENTS

Effective January 1, 2008, the Fund adopted FASB Statement No. 157, *Fair Value Measurements* (now included in FASB Accounting Standards Codification Topic 820, *Fair Value Measurements and Disclosures*, or ASC Topic 820 and FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (now included in FASB Accounting Standards Codification Topic 825, *Financial Instruments*, or ASC Topic 825). ASC Topic 820 provides a definition of fair value which focuses on an exit price rather than an entry price, establishes a framework for measuring fair value which emphasizes that fair value is a market-based measurement, not an entity-specific measurement, and requires expanded disclosures about fair value measurements. ASC Topic 825 provides companies with the option to report eligible financial assets and financial liabilities at fair value on an instrument-by-instrument basis. This option is available when an entity first recognizes a financial asset or financial liability or upon signing a firm commitment. In addition, ASC Topic 825 allows a one-time election for existing qualifying financial assets and liabilities. Upon adoption of ASC Topic 825, the Fund elected to account for its notes payable at fair value in part to comply with industry reporting standards that require all debt liabilities to be reported at fair value. The adoption of ASC Topic 820 and ASC Topic 825 did not have a material impact on the Fund's financial position or results of operations on the effective date.

To increase consistency and comparability in fair value measurements and related disclosures, the Fund utilizes the fair value hierarchy required by ASC Topic 820 which prioritizes the inputs to valuation techniques used to measure fair value into three broad levels:

Level 1 - Inputs that reflect unadjusted quoted prices in active markets for identical assets or liabilities that the Fund has the ability to access at the measurement date.

Level 2 - Inputs other than quoted prices that are observable for the asset or liability either directly or indirectly, including inputs in the markets that are not considered to be active.

Level 3 - Inputs that are unobservable.

Inputs are used in applying the various valuation techniques and broadly refer to the assumptions that market participants use to make valuation decisions, including assumptions about risk. Inputs may include price information, volatility statistics, specific and broad credit data, liquidity statistics, and other factors. An investment's level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. However, the determination of what constitutes "observable" requires significant judgment by the Advisor. The Advisor considers observable data to be that market data which is readily available, regularly distributed or updated, reliable and verifiable, not proprietary, provided by multiple, independent sources that are actively involved in the relevant market. The categorization of an investment within the hierarchy is based upon the pricing transparency of the investment and does not necessarily correspond to the Advisor's perceived risk of that investment. Substantially all of the Fund's investments have been classified within level 3 as the related fair value measurements generally utilize significant unobservable inputs.

The following table presents the Fund's assets and liabilities measured at fair value on a recurring basis and their respective position in the fair value hierarchy as of December 31, 20x2 (000's):

DESCRIPTION	TOTAL	LEVEL 1	LEVEL 2	LEVEL 3
Real estate equity investments	79,889	-	-	79,889
Real estate debt investments	53,500	-	-	53,500
Notes payable	(50,000)	-	-	(50,000)

The following is a reconciliation of assets and liabilities for which significant unobservable inputs (level 3) were used in determining fair value:

	REAL ESTATE EQUITY INVESTMENTS	REAL ESTATE DEBT INVESTMENTS	NOTES PAYABLE
Beginning balance	78,898	53,000	(85,206)
Realized and unrealized gains	17,100	500	-
Cost of purchases	250	-	-
Proceeds of sales	(16,859)	-	-
Principal repayments	-	-	35,206
Ending balance	79,889	53,500	(50,000)
Amount of unrealized gain/loss reported in the statement of operations attributable to investments held at year end	14,500	500	-

4. NOTES PAYABLE

The accompanying schedule of notes payable presents financing that is recorded in the accompanying statement of net assets as well as financing that is contained within the Fund's private real estate equity investments. Even when the fund's ownership interest in an underlying private real estate equity investment is less than 100%, such financing is presented in the table below at 100% of the underlying amounts.

	COLLATERAL	RATE	TERMS	MATURITY DATE	2002 AMORTIZED COST (000'S)	2002 FAIR VALUE (000'S)
Fund line of credit	Capital Commitments	7.50%	Fixed	Oct 20x5	\$50,000	\$50,000
Property A*	Office property	7.50%	Fixed	Jan 20x5	37,964	39,050
Property B	Office property	4.80%	Variable	Jun 20x9	12,090	12,090
Property C	Multifamily Property	7.00%	Fixed	Dec 20x9	35,399	38,000
Property D*	Industrial	7.00%	Fixed	Dec 20x9	\$10,764	\$13,000
Venture A	Office property	7.50%	Fixed	Oct 20x5	13,354	15,000
Venture B	Office property	5.60%	Variable	Jul 20x9	30,739	30,739
Investment financing					\$140,310	\$147,879

* - The Fund has provided indemnifications to lenders for losses incurred in the event of fraud or other misconduct. The maximum exposure under such indemnification is generally limited to the outstanding balance of the related loans plus expenses incurred as a result of such fraud or misconduct. The Fund has not had prior claims or losses pursuant to these contracts and expects the risk of loss to be remote.

A summary of notes payable principal payments due over the next five years and thereafter for financing recorded in the accompanying statement of net assets is as follows:

	(000's)
2003	\$ 0
2004	0
2005	50,000
2006	0
2007	0
Thereafter	0
Total	\$ 50,000

There is no guarantee that the Fund's borrowing arrangements or other arrangements for obtaining leverage will continue to be available, or if available, will be available on terms and conditions acceptable to the Fund. Unfavorable economic conditions also could increase funding costs, limit access to the capital markets or result in a decision by lenders not to extend credit to the Fund. In addition, a decline in the fair value of the Fund's assets may have particular adverse consequences in instances where the fund borrowed money based on the fair value of those assets. A decrease in the fair value of

those assets may result in the lender requiring the Fund to post additional collateral or otherwise sell assets at a time when it may not be in the Fund's best interest to do so. In the event the Fund is required to liquidate all or a portion of its portfolio quickly, the Fund may realize significantly less than the value at which it previously recorded those investments.

Operating Model

NOTE 3: FAIR VALUE MEASUREMENTS

In determining fair value, the Company uses various valuation approaches. ASC Topic 820 establishes fair value measurement framework, provides a single definition of fair value, and requires expanded disclosure summarizing fair value measurements. ASC Topic 820 emphasizes that fair value is a market-based measurement, not an entity-specific measurement. Therefore, a fair value measurement should be determined based on the assumptions that market participants would use in pricing an asset or liability.

The statement establishes a hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the most observable input be used when available. Observable inputs are inputs that the market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the Company. Unobservable inputs are inputs that reflect the Company's assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances. The hierarchy is measured in three levels based on the reliability of inputs:

- Level 1 – Valuations based on quoted prices in active markets for identical assets or liabilities that the Company has the ability to access. Valuation adjustment and block discounts are not applied to Level 1 instruments.
- Level 2 – Valuations based on quoted prices in less active, dealer or broker markets. Fair values are primarily obtained from third party pricing services for identical or comparable assets or liabilities.
- Level 3 – Valuations derived from other valuation methodologies, including pricing models, discounted cash flow models and similar techniques, and not based on market, exchange, dealer, or broker-traded transactions. Level 3 valuations incorporate certain assumptions and projections that are not observable in the market and significant professional judgment in determining the fair value assigned to such assets or liabilities.

In instances where the determination of the fair value measurement is based on inputs from different levels of the fair value hierarchy, the level in the fair value hierarchy within which the entire fair value measurement falls is based on the lowest level input that is significant to the fair value measurement in its entirety.

The following is a description of the valuation techniques used for investments measured at fair value:

Real Estate Properties

The values of real estate properties have been prepared giving consideration to the income, cost and sales comparison approaches of estimating property value. The income approach estimates an income stream for a property (typically 10 years) and discounts this income plus a reversion (presumed sale) into a present value at a risk adjusted rate. Yield rates and growth assumptions utilized in this approach are derived from market transactions as well as other financial and industry data. The cost approach estimates the replacement cost of the building less physical depreciation plus the land value. Generally, this approach provides a check on the value derived using the income approach. The sales comparison approach compares recent transactions to the appraised property. Adjustments are made for dissimilarities which typically provide a range of value. Generally, the income approach carries the most weight in the value reconciliation.

Investment values are determined quarterly from restricted appraisals, in accordance with the Uniform Standards of Professional Appraisal Practice ("USPAP"), which include less documentation but nevertheless meet the minimum requirements of the Appraisal Standards Board and the Appraisal Foundation and are considered appraisals. In these appraisals, a full discounted cash flow analysis, which is the basis of an income approach, is the primary focus. Interim monthly valuations are determined by giving consideration to material investment transactions. Full appraisal reports are prepared on a rotating basis for all properties, so each property receives a full appraisal report at least once every three years.

Since appraisals take into consideration the estimated effect of physical depreciation, historical cost depreciation and amortization on real estate related assets has been excluded from net investment income.

The values of real estate properties undergoing development have been prepared giving consideration to costs incurred to date and to key development risk factors, including entitlement risk, construction risk, leasing/sales risk, operation expense risk, credit risk, capital market risk, pricing risk, event risk and valuation risk. The fair value of properties undergoing development includes the timely recognition of estimated entrepreneurial profit after such consideration.

During 20x8 and 20x7, all appraisals for the Company were prepared by independent external appraisers. The external appraisals are reviewed by an external appraisal management firm. All appraisal reports and appraisal reviews comply with the currently published USPAP, as promulgated by the Appraisal Foundation. The Company's real estate properties are generally classified within level 3 of the valuation hierarchy.

Real Estate Joint Ventures and Limited Partnerships

Real estate joint ventures and certain limited partnerships are stated at the fair value of the Company's ownership interests of the underlying entities. The Company's ownership interests are valued based on the fair value of the underlying real estate, any related mortgage loans payable, and other factors, such as ownership percentage, ownership rights, buy/sell agreements, distribution provisions and capital call obligations. Upon the disposition of all real estate investments by an investee entity, the Company will continue to state its equity in the remaining net assets of the investee entity during the wind down period, if any that occurs prior to the dissolution of the investee entity. The Company's real estate joint ventures and limited partnerships are generally classified within level 3 of the valuation hierarchy.

Marketable Securities

Equity securities listed or traded on any national market or exchange are valued at the last sale prices as of the close of the principal securities exchange on which such securities are traded or, if there is no sale, at the mean of the last bid and asked prices on such exchange, exclusive of transaction costs. Such marketable securities are classified within level 1 of the valuation hierarchy.

Debt securities, other than money market instruments, are generally valued at the most recent bid price of the equivalent quoted yield for such securities (or those of comparable maturity, quality, and type). Money market instruments with maturities of one year or less are valued in the same manner as debt securities or derived from a pricing matrix. Debt securities are generally classified within level 2 of the valuation hierarchy.

Mortgage Loans and Notes Receivable

The fair value of mortgage loans and notes receivable held by the Company have been determined by one or more of the following criteria as appropriate: (i) on the basis of estimated market interest rates for loans of comparable quality and maturity, (ii) by recognizing the value of equity participations and options to enter into equity participations contained in certain loan instruments and (iii) giving consideration to the value of the underlying collateral. The Company's mortgage loans and notes receivable is classified within level 3 of the valuation hierarchy.

Mortgage Loans and Notes Payable

The fair values of mortgage loans and notes payable are determined by discounting the future contractual cash flows to the present value using a current market interest rate. The market rate is determined by giving consideration to one or more of the following criteria as appropriate: (i) interest rates for loans of comparable quality and maturity, and (ii) the value of the underlying collateral. The Company's mortgage loans and notes payable are generally classified within level 3 of the valuation hierarchy.

The following are the major categories of assets and liabilities measured at fair value on a recurring basis during the year ended December 31, 20X8, using unadjusted quoted prices in

active markets for identical assets (Level 1); significant other observable inputs (Level 2); and significant unobservable inputs (Level 3):

Description	Level 1: Quoted Prices in Active Markets for Identical Assets	Level 2: Significant Other Observable Inputs	Level 3: Significant Unobservable Inputs	Total at December 31, 20X8
Real estate properties	\$ —	\$ —	\$ 3,500,000	\$,500,000
Real estate joint ventures and limited partnerships	—	—	240,000	40,000
Marketable securities - real estate related	530,000	—	—	30,000
Marketable securities - debt securities	—	350,000	—	50,000
Mortgage loans and notes receivable	—	—	2,750,000	,750,000
Total Investments	\$ 530,000	\$ —	\$ 6,490,000	\$,370,000
Mortgage loans and notes payable	\$ —	\$ —	\$ 5,900,000	\$,900,000

The following is a reconciliation of the beginning and ending balances for assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during the year ended December 31, 20X8:

	Real estate properties	Real estate joint ventures and limited partnerships	Mortgage loan and notes receivable	Total Level 3 Investments	Mortgage Loans Payable
Beginning balance - January 1, 20X8	\$ 2,850,000	\$ 530,000	\$ 2,200,000	\$ 5,580,000	\$ 6,250,000
Total realized and unrealized gains (losses) included in changes in net assets	570,000	(320,000)	550,000	800,000	(450,000)
Purchases, issuances,	80,000	30,000	-	110,000	100,000

and settlements	_____	_____	_____	_____	_____
Ending balance - December 31, 20X8	\$ <u>3,500,000</u>	\$ <u>240,000</u>	\$ <u>2,750,000</u>	\$ <u>6,490,000</u>	\$ <u>5,900,000</u>