Adoption Date: 1 February 2004
Revised Effective Date: 1 January 2006
~~**Effective Date: 1 January 2005**~~
Retroactive Application: No
Public Comment Period: Jul – Dec 2002

Interpretive Guidance for Real Estate

Introduction and Scope

The GIPS standards Real Estate provisions apply where returns are primarily derived from the holding, trading, development, or management of real estate assets. Real estate includes land, buildings under development, completed buildings, and other structures or improvements held for investment purposes. The Standards apply to firms managing real estate regardless of the level of control the firm has over management of the real estate investments (see the discussion of discretion below). The provisions apply irrespective of whether a real estate investment is producing revenue and also apply to real estate investments with leverage or gearing.

Investment types not considered as real estate and therefore addressed elsewhere in the general provisions of the GIPS standards include the following:

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

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

Recognizing that firms may not be able to gather historical valuations and/or records for transactions of real estate assets in order to create a five-year performance history, firms may link non-compliant performance for these assets for periods prior to 1 January 2006 to compliant performance with appropriate disclosure as to why the performance is not in compliance with the Standards.

Compliance

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

Composite Construction

The real estate investment industry continues to debate the efforts, alternatives, and meaningful relevance of composite construction. One of the key principles of the GIPS standards is the notion of the presentation of composite performance, where a composite is defined as an aggregation of one or more portfolios representing a particular investment objective or strategy. The real estate provisions of the GIPS standards embrace the notion of composite-level reporting and require real estate investment management firms to present performance in composites defined by investment objective or strategy.

Users and recipients of performance presentations, however, frequently request property-level performance presentations, which may not be consistent with the composite construction principles of the GIPS standards. While firms are not prohibited from presenting information according to specific requests from prospective clients, firms are required to make every reasonable effort to provide a fully compliant presentation of a composite based on investment objective or strategy.

For example, the GIPS composite construction provisions require firms to prepare composites, where the composite tracks the investment strategy that is pursued for a client or group of clients. But a real estate investment management firm may be asked to prepare a presentation consisting of only their office building investments, which requires extracting the performance of all office building investments from multiple portfolios within the firm.

If this grouping represents what would have been achieved with a strategy dedicated to office building investments, the firm may consider this a composite consisting of carve outs and apply the GIPS carve-out provisions and guidance (see the Guidance Statement on the Treatment of Carve Outs). If this grouping does not represent what would have been achieved with a strategy dedicated to office building investments, carving-out the property-level office building investment returns from portfolios with vastly different investment objectives and strategies will likely not satisfy the composite construction requirements of the Standards. This property-level grouping should then only be presented as supplemental information to a compliant composite presentation (see the Guidance Statement on the Use of Supplemental Information).

Discretion

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

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

> *Discretionary Management:*
> Real estate portfolios are considered discretionary if the firm has sole or primary responsibility for major investment decisions. Major decisions may include portfolio strategy, investment search and selection, purchases, sales, investment structuring, financing, capital improvements, and operating budgets. Clients may not delegate complete investment discretion to firms for real estate investments, but in many cases, the consent requirements and investment constraints imposed do not inhibit the firm's investment policy or decision making to any significant extent. Therefore, the existence of client-imposed investment restrictions such as leverage limits or required client approval of major decisions do not preclude classification of a real estate portfolio as discretionary. Acceptance of primary responsibility by the firm and, therefore, the presence of a discretionary management relationship may be inferred if a portion of the firm's compensation is tied to performance or if the firm's success is assessed based on comparison of the firm's performance to a selected industry benchmark.
>
> *Nondiscretionary:*
> Real estate portfolios are considered nondiscretionary if client-imposed investment limitations and restrictions hinder or prohibit application of the firm's desired investment strategy. As an example, taxable clients may prohibit or significantly limit repositioning of their portfolios through active or timely sales in order to minimize capital gains taxes. Alternatively, clients may mandate liquidation of their portfolios at a time when the firm believes pricing is not optimal. Additionally, firms may accept special assignments, such as portfolios taken over from other firms, with mandates that are not consistent with their own investment strategy.

Time-Weighted and Internal Rate of Return

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

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

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

Separation of Income and Capital Appreciation Components

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

Disclosures

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

Requirements:

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

Valuation

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

a. Buyer and seller are typically motivated;
b. Both parties are well informed or well advised, and each party is acting in what they consider their own best interests;
c. A reasonable time is allowed for exposure in the open market;

d. Payment is made in terms of cash currency or in terms of financial arrangements comparable thereto; and,
e. The price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.

Source of Valuation

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

There are two sources of property valuation:

Independent Valuation:

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

Internal Valuation:

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

Frequency of Valuation of Real Estate:

Requirements:

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

Recommendations:

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

Income Return

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

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

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

Application:

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

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

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

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

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

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

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

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

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