

We must encourage the fund management community to be more diligent in assessing and reporting fund values, says **Rob Kochis**

# Let there be light

Investors beware: the next real estate fund proposal you see is probably too good to be true. The past five years witnessed a bull market in real estate that we have not seen in nearly 20 years. In a market reasonably characterised as frenzied, managers deployed investment capital at a pace heretofore not seen. So far, performance has been strong, and everybody has prospered.

For a real estate fund manager, what a marketing gold mine. Now, both the established and the 'would-be' are rushing to market with investment products to amass new capital commitments. And nearly every manager today can point to attractive recent performance.

The problem, all too often, is that managers point to attractive recent performance based upon projections – estimates of what its property investments are worth today and what they will be worth in the future. At hand is the often murky world of private market fund valuations. In order to distinguish between the truly good and those who merely rode the market wave, investors must assess the value of unrealised, or not yet sold, investments still on the manager's books. This is particularly important when the market turns; when the wave begins to recede.

At a recent investor conference sponsored by a real estate manager, investors asked about the impact of the current debt market turmoil. "Values are down in New York, in London, in Paris," the manager agreed. "Did that market correction impact the manager's investments in those markets," the investors asked? "No," the manager responded, "our investments are conservatively carried at cost." The manager was confident that no value had been lost. Now, with its projected 20% returns intact, the manager is seeking to raise the largest pooled fund in its history, nearly double the size of its last.

Real estate investors are notorious for their optimism and for falling in love with their properties. However, a property's projected performance is inextricably tied to how a manager has valued that asset on its balance sheet. Holding an asset at "cost" in a declining market most likely means the manager is not capitulating and reporting to its investors (current and prospective) that its investments have lost value and assuredly cannot deliver the performance projected. Even if managers have properties appraised, those appraisals are notoriously subjective, and they occur too infrequently. Managers must employ a diligent mark-to-market value discipline in order for investors to make smart decisions during volatile markets like those experienced last year.

Thank goodness that an association of industry professionals is attempting to address these issues in non-listed real estate investment vehicles.

INREV's first steps have been to identify elements that managers must take into account when reporting the value of a real estate fund investment to their investors. It is a good foundation upon which to build. The much more difficult work ahead will identify the valuation approaches and calculation methods to determine those elements. Future efforts will also push the fund manager community to be more diligent in assessing and reporting investment values. Below are a few thoughts on what needs to be addressed:

■ **Frequency and promptness.** Institutional real

estate investors desire accurate quarterly reporting at a minimum. Unfortunately, most fund managers do not make an effort to assess property values quarterly. It appears that the most common approach, especially among "opportunity" fund managers, is to assess values once a year, usually at the prompting of a third-party auditor. As values on the books become stale, investors are set up for surprise. Recently, the market was frothy and that surprise was often happy. Buyers were purchasing at ever higher prices and performance often exceeded expectation. It now appears the rising tide is past. Going forward, managers who make infrequent attempts to estimate value, to reassess assumptions, to make new projections, may deliver unhappy surprises when properties are realised (sold) at values less than those last reported to investors.

Equally important is reporting promptly. The typical reporting cycle we observe is 60-90 days (after quarter-end). This is simply too long. Non-listed real estate funds should strive to report updated values within 30 days of the end of a quarter. Institutional investors with multi-asset class portfolios require better information to manage their total portfolio – to make decisions affecting allocations to stocks, bonds, and real estate, for instance. The time currently

required to report most real estate fund results leads most investors to lag them, by including them in the next quarter's total portfolio reporting. It is not uncommon for an investor to be looking at real estate results nearly six months stale by the time they see them in a comprehensive report covering all the investor's public and private market investments.

■ **Frequency and promptness.** Valuation practices are still too varied. Although there are notable exceptions, institutional open-end funds we observe have higher quality mark-to-market disciplines. Because they must satisfy quarterly investor deposits and withdrawals, the best have invested in their financial systems and created valuation groups to look at the value of every property each quarter. They adjust cash flow projections quarterly based upon actual results and can quickly assess values through widely used metrics such as discount or capitalisation rates. They can check values derived by discounted cash flow methods against prevailing market knowledge of pricing per square metre or foot. They have invested in their "back office" so they are able to release results 20 to 30 days after the end of a quarter.

Many have also been willing to delegate significant authority to third-party valuation firms that monitor and approve property values each quarter. Such outsourcing adds an element of independence to, and confidence in, reported values.

Unfortunately, most closed-end non-listed real estate funds do not commit to restate values periodically. Most hold their assets at investment cost. One must ask: are the cost-basis funds currently overstating values (and their performance) in light of the

recent correction that occurred in property values in the United States and many European markets?

Other closed-end non-listed funds claim to have a "mark-to-market" policy, but they are reactive rather than proactive. This makes them much less helpful to investors. Values are adjusted haphazardly only when information becomes available to a fund manager. For example, additions to "cost" are booked if significant capital improvements are made. A manager may adjust a value if a lender completes an appraisal when placing a mortgage on a property. Some will adjust a property's value based upon an offer to purchase, even if it is not consummated. Lumpy changes in-value result.

Within a fund, properties are valued piecemeal, rather than looking at all with a consistent approach at the same time. Because these reactive approaches vary so widely, investors can make little comparison between funds, even funds in the same vintage investment period. Investors have less confidence that investments are on track to deliver a manager's projected results.

■ **Debt mark-to-market.** Real estate is a leveraged investment, so a valuation must take into account both the asset and liability sides of the balance sheet. Rational buyers account for an assumable

mortgage when pricing a bid for a property. The property is worth more if geared with debt at a fixed interest rate below the current prevailing rate; less if geared with debt above prevailing rates.

Here too,

INREV requires market valuation of debt, but there appears to be wide inconsistency in the methods employed. The most common method is to discount a loan's current value based upon prevailing interest rates. However, choosing the right prevailing rate can be tricky. For example, rates vary based upon the term of the loan. For a comparable market rate, should a manager look to a loan with a maturity equal to the manager's actual remaining term or its original face term? Some managers try to aggregate multiple loans and use the weighted average rate and maturity for purposes of the market value exercise. Some managers do not want to value the debt of every property. Instead, they value only debt secured by properties held for near-term sale. Thus, two properties with identical debt may have totally different adjustments to value, simply because the manager does not intend to sell both in the near term.

Portfolio level debt also raises problems. How should a manager treat a portfolio-level loan secured by a pool of properties? Often, it can sell a property free and clear without buyer discounts and without incurring yield maintenance charges (through substituting another property for the one sold, for example). However, the manager could not pre-pay the total loan without incurring some penalty. In such cases, should the current market value of the portfolio debt affect the overall fund's value?

## 2000-01 VINTAGE NON-LISTED REAL ESTATE OPPORTUNITY FUNDS

	%
Total number of funds	31
Top performing fund	67.9
Top quartile average	46.5
Median performance	27.8
Spread: between average of top and third quartiles	27.2
Bottom quartile average	8.7
Bottom performing fund	2.8

Source: Townsend Group. Note: all returns annualised gross since inception

Some managers apply a materiality threshold. For example, if marking all the debt in a fund to market value does not affect the value of total liabilities by more than, say, 3%, then the manager need not report any value adjustment at all.

An additional word on debt is appropriate in today's environment. The industry generally accepts that only fixed rate debt need be adjusted to market value, whereas variable rate debt adjusts automatically. However, even variable rate debt comes with a maturity date. Under today's credit market conditions, managers can no longer assume that variable rate loans can be renewed or refinanced in the same amounts. Wouldn't a property's value be impaired if a manager knows it will not be able to secure a new mortgage in the same amount when an existing mortgage loan comes due? How will finite-life closed-end funds secure the extra equity they need if lenders will not loan at the levels previously attainable? This is a developing issue that may, unfortunately, create new unhappy surprises for fund investors, because admitting new equity partners in lieu of using high levels of debt may impair a property's value.

■ **Currency.** With globalisation continuing at a rapid pace, non-listed funds are being offered in all sorts of currencies (more frequently in illiquid currencies of developing countries). Many funds also invest in multiple countries, creating a host of currency translations within the fund. We have observed celebrated cases where perfectly good and successful property investments lost profits and values through the translation back to the investor's home currency. More and more, investors are left to manage this risk on their own.

Some object that adjusting values for currency fluctuations only adds additional volatility unrelated to real

estate markets or the merits of a particular property investment.

Nevertheless, accurate and timely reporting from managers is necessary if investors are to manage currency risk. Investors will often look across asset classes to assess macro-currency exposures for their entire investment portfolio (stocks, bonds, private equity, real estate, etc.). If exposure to a particular country or currency becomes too high, many investors have currency consultants or risk management teams that will implement a hedge. Likewise, if profits are reasonably foreseeable in the near term, they may elect to lock them in at a given spot rate.

Ideally, managers should account for foreign currencies with each quarterly report to investors. A fund's aggregate gains or losses attributable to currency fluctuation should be reported on the balance sheet, with each investor's pro-rata share reported on its capital statement. Managers should disclose the calculation methods used for making any adjustments. Any hedges instituted by the manager in favor of the fund's denominated currency should be disclosed, so that investors do not duplicate that hedge on their own.

Without such basic information as a timely and accurate value, a non-listed real estate commingled fund stands out as a more time consuming and less manageable investment, relative to traditional investment classes. Currently, institutional investors too often must create exceptions for real estate, rather than incorporating it smoothly into their risk management policies and procedures. That is one reason why INREV's efforts to develop basic industry standards for valuing non-listed real estate funds is so important.

Equally important, we believe, is the empowerment that comes from diligent implementation of clear industry standards for fund valuations. Not only can investors manage better their existing investments, but they can develop tools to help them make better investment choices prospectively. This has never been more important than in today's dynamic investment environment.

As already mentioned, the last two or three years has witnessed a surge of new offerings of non-listed real estate vehicles. Currently, some 380 managers are offering more than 500 real estate funds for investment. The growing variety is striking. Long past traditional "core" investing, real estate funds today are structured to capitalise on public and private market opportunities in both real estate equity and debt strategies. Private market strategies span the risk spectrum, from stabilised to value added to the most opportunistic. New markets have opened around the globe. Global "allocator" funds are competing for capital with regional experts and "rifle shot" funds that target a particular country, metropolitan area, or property type (a Japanese Logistics fund, for example).

The pace has quickened too. Whereas it was once not uncommon for a manager to need more than 12 months to raise a private market fund, today, the best are quickly oversubscribed. Some are not marketed widely outside an existing investor base.

Investors are forced to make quick decisions or risk getting closed out of a fund by a flood of competing investor capital.

How are investors to choose between all these offerings? Moreover, as this surge of new funds comes to market, have we all been lulled into a sense of invincibility because of apparent outstanding recent performance? How can a manager's recent performance be assessed when it is tied to unrealised properties that have not been periodically valued in a consistent and diligent way under industry standards followed by the majority of that manager's peers? Without a history of reporting accurate valuations, how do investors know that a manager's performance has truly been above the average manager or simply the product of "market lift?"

Investors desire to invest with best-in-class managers, because the disparity in manager performance can be huge during good times and bad. We recently compared the non-listed opportunity funds born during the early years of this decade (during the technology crash, terrorist attacks and ensuing global recession in 2000-01). With hindsight, this seemed to have been a good time to launch a real estate fund: at the bottom of an economic cycle, with a long-term economic recovery ahead.

While even the average fund did well since then, the spread in average annual returns over nearly seven years was more than 6500 basis points when comparing the best performer with the worst fund. The average performance by quartile (eg, the average of the top 25% of funds in this group) also resulted in material spreads in performance: 2,700 basis points between the average of the top quartile and the average of the third quartile just below the median.

As industry standards and manager reporting improve, such rankings will become more widely available and more precise. For example, investors will be able to compare prior funds with or without vintage year rankings. Relative fee loads could be compared to distinguish high-cost and low-cost investment alternatives. Speciality strategies could be compared, such as grouping managers targeting a particular country or property type (hotel investors, for instance). INREV is contributing to this evolutionary process.

**Rob Kochis is a principal at the Townsend Group**