Real Estate Private Equity Funds

Real estate equity capital funds and their sponsors are under pressure from investors to provide greater transparency and standardization in reporting information and to meet yet-to-be-defined performance standards. Are they up to the challenge?

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THE LATE 1970S and early 1980s witnessed the emergence of private equity investment funds that provided the equity necessary to execute leveraged buyouts (LBOs) of companies with solid, albeit modestly growing, cash flows. Led by firms such as KKR and Forstman Little, investment companies created numerous limited partnership private equity funds. The investment company (sponsor) acted as the general partner and also made a substantial side-by-side investment in the fund. The sponsor received management and transaction fees as well as a carried interest that was subordinated to a preferred return on investors' capital (including the sponsor's investment). Fueled by

commitments from both high wealth and institutional investors willing to accept higher risks in exchange for higher expected returns, these funds financed the LBO explosion. LBO funds expanded in the 1990s as institutional investors flocked to new funds created by sponsors such as Blackstone, Apollo, Thomas Lee, Goldman Sachs, and Hicks Muse.

Until the late 1980s, LBO funds ignored real estate. This may seem surprising because real estate frequently would have provided the relatively stable cash streams sought by LBO funds. The reason was that owners and developers of real estate had already used non-recourse debt, often well in excess of 100 percent of cost, to finance their properties. In a world of near-100-percent debt financing, the equity pools provided by private equity firms were irrelevant, as real estate could be owned by entrepreneurs with little or no equity.

EARLY FUNDS

In 1988, Sam Zell sensed that the excessive leveraging of properties could not continue and lenders would soon be forced to foreclose on non-performing properties. In order to successfully acquire foreclosed properties from lenders reducing their real estate loan exposures, he surmised that large amounts of equity would be required. To amass a war chest for such acquisitions, the Zell-Merrill I real estate opportunity fund raised $409 million, using the private equity fund partnership structure.

This fund was ahead of its time. However, by 1991, new real estate debt had all but disappeared and lenders everywhere had non-performing loans and were foreclosing on quality properties. At the same time, the federal government was accumulating vast pools of non-performing real estate loans and lesser quality properties in foreclosure of insolvent financial institutions — primarily savings and loans via the Resolution Trust Corporation (RTC). Traditional real estate owners and developers lacked the equity to purchase and make the necessary tenant improvement expenditures for these properties because lenders were only willing to lend 50 percent to 60 percent of value. As a result, the Zell-Merrill I fund was often the only potential buyer for high quality properties, while the RTC's lesser quality assets generally languished without viable buyers.

Goldman Sachs realized that greater profits could be achieved by purchasing and reselling the underlying properties, or restructuring the non-performing loans, than by acting as a fee-based advisor to the RTC on the disposition of these assets. To provide the equity to take advantage of this opportunity as a principal, rather than an agent, Goldman used the basic private

equity fund model to form the $166 million Whitehall I Fund in late 1991, and the $790 million Whitehall II Fund in late 1992. In addition to Goldman, the investors in these funds were primarily high wealth investors. Institutional investors displayed very little appetite for additional real estate exposure through these early funds, as most already had large de facto real estate exposure through their ownership of the major banks. In addition, institutional real estate investors were reeling from the losses on their core property portfolios and generally avoided land, incomplete developments, and lower quality properties such as those securing the RTC's loans.

The success of these initial real estate private equity funds led others to create real estate-focused private equity funds. These new funds generally emulated either Zell-Merrill's focus on acquiring quality properties from financial institutions, or Goldman's strategy of wholesale loan pool acquisitions from lenders (particularly the RTC). Investment companies such as Angelo Gordon, Apollo, Blackstone, Cerberus, and Soros created real estate funds, as did leading investment banks such as CSFB, Lehman Brothers, and Morgan Stanley. In addition, many real estate-oriented fund sponsors appeared, including AEW, Colony, JE Robert, Lone Star, Lubert-Adler, O'Connor, Starwood, Walton Street, and Westbrook.

Since the original Zell-Merrill I fund began, real estate private equity funds have raised approximately $100 billion in equity. Most of the investments by the earliest funds have been harvested and returned to investors, either as cash or shares in publicly traded companies. In fact, two of the largest publicly traded real estate companies, Equity Office Properties and Starwood Hospitality, trace their roots to early opportunity fund portfolios.

FUNDS VS. REITS

Together with real estate investment trusts (REITs), real estate private equity funds have filled the equity gap that occurred as real estate financing integrated with global capital flows. Beyond obvious liquidity differences, private equity funds differ from REITs in several important ways. While most REITs have annual total equity return expectations (dividends plus appreciation) in the range of 10 percent to 14 percent, real estate private equity funds have annual equity return expectations of at least 15 percent and generally in excess of 20 percent. Real estate private equity funds invest in situations with relatively higher risks than REITs in order to achieve their target returns.

Another distinction between real estate private equity funds and REITs is that REITs tend to own stabilized income-

producing properties with a long-term operating focus, while private equity funds generally hold properties for three to five years and generally invest in non-stabilized assets. As a result, real estate opportunity funds tend to be relatively more "traders" and "value enhancers" as opposed to "operators," frequently pursuing event-driven assets. For example, they are relatively more active in funding development, redevelopment, and loan workouts than are REITs.

In their pursuit of higher returns, real estate private equity funds tend to use significantly higher leverage than REITs. It is important to bear in mind that a property with rents growing at 2 percent to 3 percent annually, with a current yield of 9 percent and 70 percent leverage at a 6.5 percent interest rate, can achieve the pro forma return targets of real estate private equity funds.

TRANSFORMING REAL ESTATE FINANCING

Real estate private equity funds have changed the face of private real estate financing for two reasons. First, to the extent that institutional investors provide their capital, real estate equity funds represent a structural improvement in how such investors invest in real estate. Prior to the emergence of opportunity funds, institutional investors generally hired specialized real estate managers to invest for them via separate accounts and commingled funds. These managers were compensated by a transaction fee and by a percentage of the appraised property value. Thus, real estate management firms had a strong incentive to mark up the value of their properties in order to increase their fee income (and no incentive to mark down). Further, managers did not invest alongside their institutional investors, so they were rewarded even when their clients lost money. This system of institutional real estate management largely blew up in the early 1990s, as institutional investors realized that their managers had been marking up the value of their properties, even as property values were collapsing.

In contrast to traditional real estate investment managers, real estate private equity fund sponsors are compensated by a 1 percent to 2 percent fee on committed capital, perhaps a transaction fee, and a carried interest that is subordinated to a preferred return on investors' money (including money invested by the sponsor). Sponsors receive no additional fee income if their properties rise in value. That the bulk of their compensation comes in the form of a subordinated carried interest (generally 20 percent of all profits) based upon absolute return creates a much stronger alignment of interests. Should the fund fail to exceed the pre-

ferred rate of return, the fund sponsor's carried interest is worthless.

Equally important in terms of incentive compatibility is that fund sponsors invest side-by-side with their investors. Generally 2 percent to 25 percent of all of the capital committed to a real estate private equity fund is committed by the sponsor. In a few cases, the sponsor's own investment is even subordinated to other investors'. Thus, the real estate private equity model for institutional investment represents a vast improvement on the traditional model.

Real estate private equity funds have impacted the landscape of real estate finance in a far more subtle manner. Since approximately 40 percent of the funds committed to these funds comes from high-wealth investors, a traditional source of deal financing for local real estate entrepreneurs has been largely eliminated. Specifically, local real estate entrepreneurs historically have tapped into their local networks of high-wealth individuals whenever they required substantial equity for their deals. Historically, these high-wealth investors were provided tax shelters, and also received 50 percent of the profits on a deal after a fee was paid to the local real estate developer or operator. However, increasingly, high-wealth individuals are selecting the alternative of investing in real estate through well-known real estate private equity funds. This alternative provides high-wealth individuals with greater geographic, property, and managerial diversification, as well as less personal involvement. Further, in a world without tax shelters, the terms offered by real estate private equity funds are generally far more attractive, as the investor pays about the same fee, while receiving a preferred return, and gives up 20 percent of the profits only if the preferred return target is achieved.

As a result of competition from real estate private equity funds, local real estate entrepreneurs are finding it more difficult to put together syndicates of high-wealth individuals for large deals, as these individuals have already invested their real estate investment allocations in real estate private equity funds. Frequently, high-wealth individuals tell local real estate entrepreneurs seeking money that they should talk to the funds in which they have invested. Increasingly, real estate entrepreneurs are financed by real estate private equity funds, which are more informed than the typical high-wealth individual.

STRUCTURAL SHORTCOMINGS

While real estate private equity funds provide a major improvement on previous private investment models for real estate, investors should be aware of several potential shortcomings of all private equity

funds. The first is that if a fund registers only mediocre investment performance, a 20 percent share of profits provides the sponsor with a disproportionate compensation. In order to address this shortcoming, structures are used so that the sponsor's carried interest is not automatically 20 percent of profits once the preferred return is achieved, but instead ratchets upward toward 20 percent as the investors' return approaches 20 percent.

A second shortcoming is that for assets with so-called events (for example, loan restructuring, development, redevelopment, or significant re-tenanting efforts), much of the return is achieved only upon successful execution of the event. Subsequent to the successful resolution of the event, the annual equity return profile drops to the normal real estate return of 10 percent to 14 percent based on the current value (rather than original cost). Sponsors may hold these assets too long in order to allow their carried interest to grow, even though at the margin these assets do not meet their return targets with respect to current value. Consider the case of a property whose equity value doubles at the end of the first year due to a successful event realization, and thereafter is expected to increase at 10 percent annually (based upon post-event value). This property can be held for a long time and still achieve an IRR in excess of 20 percent (based on cost), even though the IRR on equity value after the first year is only 10 percent. Investors may prefer that the fund liquidate such investments upon successful event realization so that they can redeploy their money in other high risk/return opportunities. This potential shortcoming is to some degree dealt with by the funds' finite life, which is generally contractually established at seven to eight years, and may be extended by a majority vote of the investors for an additional one to two years. This structure reflects an attempt by the investors in illiquid investments to assure themselves that there is a definite liquidity horizon. All too often, investors in illiquid deals — particularly private real estate deals — find that their managers refuse to liquidate assets even though the investors desire liquidation. Investors should carefully monitor how much of invested capital funds have been returned to investors as a way to assess if assets are being retained long after stabilization.

Another potential shortcoming is that it is impossible for sponsors to specify exactly how they will invest, as the opportunities will change between when they begin to raise money and when the investment period ends (three to four years later). As a result, while fundraising, sponsors attempt to distinguish themselves via their investment track records. The problem is that since most funds have been in existence for relatively short time periods, most have yet

to achieve full liquidation. *Thus, it is much easier for most sponsors to demonstrate an ability to invest, than to show an ability to successfully return capital and profits to investors*. Investors are increasingly asking how the assets in a sponsor's earlier funds have performed when making their investment decision on a sponsor's new fund. This creates a perverse incentive for the sponsor to prematurely sell some of their best performing assets while holding on to their "dogs," so that they can point to successful liquidations as proof of their investment abilities, while stating that the unliquidated assets are still being worked on.

INVESTMENT STRATEGIES

Although real estate private equity funds generally utilize a common legal structure, they employ widely divergent investment strategies. While no fund employs a single strategy exclusively, most funds specialize in one or two strategies. Each strategy requires special skills, networks, and underwriting by the sponsor.

One basic strategy is to acquire high quality real estate at basically market yields and achieve the target returns on equity through structured financing. This non-opportunistic strategy is essentially the basic LBO model applied to real estate. If the property performs as expected and the spread between property yield and the borrowing rate is large, and a high proportion of the investment can be debt-financed, this is a proven strategy. Though the use of this strategy often falls under the catch phrase "opportunity fund," it is better described as a real estate LBO fund.

Many funds employ a variety of value-enhancing strategies. One such value-enhancing strategy is the acquisition of large portfolios of distressed assets (typically non-performing loans) at wholesale, and the resale of the assets at retail prices. This strategy is particularly attractive for funds sponsored by investment banks, as these sponsors possess the client base that allows them to readily identify buyers for the individual assets. In many ways, this strategy merely extends the traditional investment banking exercise of finding investors for assets, to purchasing an inventory of assets and then liquidating the assets from inventory, rather than acting as fee-based agent for the disposition.

Another value-enhancing strategy employed by some funds is to finance the development of real estate. This can take the form of either raw land development or the construction of buildings. Investments in buildings typically offer unleveraged returns that are 150 to 300 basis points in excess of those of completed properties, while land development offers unleveraged returns in excess of 15 percent. When appropriately underwritten and leveraged, development

generates pro forma equity returns in excess of 20 percent.

Redevelopment and repositioning existing properties is another value-enhancing strategy employed by several funds. These tend to be event investments, where often the asset is largely vacant or in serious disrepair. When acquired cheaply and correctly executed, this strategy also offers an attractive return with a shorter delivery time and less planning risk than new development.

The acquisition of surplus corporate real estate is another value-enhancing strategy. These assets are frequently owned by firms in or near bankruptcy, such as bankrupt retailers. Alternatively, they are the result of efforts by the corporate real estate owner to restructure their balance sheet, or rationalize their assets following a merger. History has shown that attractive returns are possible via this strategy, as once a corporate decision is made to sell, assets tend to be sold even if the economics are not particularly compelling for the seller. Similarly, several funds utilize the opportunistic strategy of purchasing real estate from government entities. However, like corporate real estate purchases, these government privatization efforts can be tedious and require a great deal of creativity to execute.

Many real estate private equity funds, particularly those sponsored by investment banks, have exported their strategies, expertise, contacts, and management techniques outside the United States. Japan and Western Europe, in particular, have witnessed substantial investment by U.S. funds. In each case, the challenge is to apply learned skills while at the same time commanding sufficient local market knowledge to act opportunistically. One of these funds' most notable skills is that they are relatively unique in their ability to quickly underwrite large portfolios, as most traditional real estate players are more comfortable focusing on single assets. Of course, the overhead associated with overseas offices requires access to a healthy deal flow.

We estimate that, using these diverse strategies, real estate opportunity funds currently control roughly $100 billion of real estate assets in the United States, as well as substantial portfolios outside of the United States. The funds' global investments consist of every type of income-producing property, and include debt (loan portfolios) and equity (common and preferred, direct and indirect ownership). Some investments are fully owned while others are majority or minority positions. Often the funds' investments are relatively illiquid and lack long histories or comparable transactions. These investments include: land; properties to be developed; loans on income properties; development and construction companies; specialized joint ventures; management companies;

private homebuilders; private executive office suite development; complex types of mortgages and receivables; senior convertible preferred; forms of subordinated debt; commercial mortgage-backed securities; real estate technology companies, and foreign loans and investments of all types.

RETURN BENCHMARKING

Real estate opportunity funds began in a period that was an extraordinary buying opportunity for real estate. As a result, most of the early funds registered excellent performance on their liquidated assets. However, relatively few of the assets acquired by funds in the latter part of the 1990s have yet to be liquidated. Thus, it is difficult to know exactly how these funds have performed.

Some investors have wondered, "Is there a meaningful return benchmark for real estate opportunity funds?" Upon careful consideration, it is clear to us that no return benchmark can be applied to real estate private equity funds. One reason is that the strategies and risk profiles employed by these funds vary widely in terms of development risk, leverage, exit liquidity, international exposure, and event risk. Funds have different investment philosophies, time horizons, and strategies. They have different investment portfolios — some focus more on completed properties than property under development, for example. Some emphasize office investments, others industrial or retail or other product types. Funds invest at different times, and with different partners, and take different risks. Since their time horizons and equity investments differ, their internal rates of return (IRRs) may not be comparable. (IRR is the rate of interest that discounts the total expected cash flows from an investment to a net present value of zero).

Some analysts have suggested that the NCREIF or NAREIT indexes provide useful benchmarks. However, NCREIF is not useful because of the well-known appraisal and timing biases in the data, and because NCREIF reflects unleveraged returns on generally stabilized U.S. assets. In contrast, the properties owned by most real estate private equity funds are heavily leveraged and not stabilized. In addition, the NCREIF data reflect the performance of properties only in the United States and therefore are not relevant benchmarks for funds with significant international exposures. Further, since many funds engage in activities such as development, redevelopment, and loan restructuring strategies, they are exposed to a different set of risks from those reflected in the NCREIF index. The NAREIT index similarly reflects the mark-to-market performance of a relatively low leveraged set of relatively high quality, well diversified domestic

properties. In addition, NAREIT captures changes in real estate stock liquidity. The United States nature of these assets is clearly inappropriate when compared to the portfolios of many internationally focused funds, while the generally higher leverage levels that exist at opportunity funds relative to REITs make performance difficult to compare. Finally, there are substantially different development and redevelopment exposures between REITs and opportunity funds, as well as very different degrees of geographic concentration.

The investments owned by real estate private equity funds tend to be unusual, since they offer the opportunity for returns well in excess of those normally associated with real estate. This makes benchmarks that utilize typical real estate returns almost necessarily inappropriate. This problem is compounded by the fact that no two funds pursue the same strategy or mix of strategies. A further complicating factor in benchmarking real estate private equity funds is that in their early years these funds run very low (and often negative) returns, as many engage in development, redevelopment, and repositioning strategies. These early-phase negative cash flow activities, which are a key element of many value-enhancing strategies, make the returns look unattractive in their early periods, as it is only as these assets reach maturity, or the event occurs, that a value pop is realized. As a result, comparing returns across funds is complicated, as one fund may be at the mature part of its life cycle, while another may be in the early phase of its life cycle. This problem also plagues attempts to create vintage-based return metrics, as even funds of the same vintage are expected to have different return patterns over time due to differences in their strategies. As a result, any attempt to benchmark returns is not only comparing apples and oranges, but is actually comparing apples to potatoes to fish. Any attempt at such benchmarking involves meaningless normalizations.

So what should investors focus on when evaluating the performance of real estate private equity funds? Ultimately, the most appropriate benchmark for real estate private equity funds is whether they are achieving their target returns using the strategies and leverage they promised investors. Simply stated, investors should evaluate whether funds are doing what they said they would do. To evaluate this over the life of the fund requires consistent and detailed reporting of information to investors, so that they can assess whether the fund is performing in line with expectations. Of particular interest is whether the fund's investments are performing in line with the original underwriting, as well as a description of the way each asset represents the fund's strategy thrust. This requires that real estate private equity funds employ transparent and consistent

reporting so that investors can evaluate these issues.

VALUATION ISSUES

As opportunity funds have grown, diversified, and expanded globally, they have come under increasing pressure from investors and their consultants to provide greater transparency and standardization in reporting information. The debate has focused primarily on the funds' performance reporting and benchmarking, but the fundamental issue is the methodology used in determining asset value, the manner and consistency with which it is reported, and the reporting consistency across funds. A recent Ernst & Young survey of real estate private equity funds (see "Opportunistic Investing and Real Estate Private Equity Funds" in this issue) found that the funds' accounting and underlying valuation and reporting practices are as varied as the funds themselves. Of the 48 respondents representing $72 billion in equity raised over the last decade, 11 indicated that they report their financial statements using historical cost accounting; four use income tax basis; and the rest said they provide fair value financial statements. Due to the complexity and diversity of their investments, survey respondents reported using many different valuation practices to determine fair value, which is the amount for which the investment could be exchanged in a current transaction between willing parties other than in a forced or liquidation sale. Some funds believed that the financial statements should be shown on a historical cost GAAP basis only and a supplementary calculation done for returns and benchmarking.

Because of the diversity of fund investments, no single valuation methodology fits every investment type. Some funds perform discounted cash flow calculations to determine fair market value for certain assets; others look for comparables. Since many of these assets have to be worked to create value, increases in value are often recognized only when the event occurs. Examples include lease-up, completion of improvements, renovations, and loan restructurings. A few funds occasionally obtain third-party appraisals. Most funds report declines in value when events indicate that their investments' performances have significantly deteriorated. Management is responsible for the financial reporting and ensuring that the significant accounting policies are disclosed.

Although a large number of funds have adopted valuation policies used by other types of private equity funds including venture capital and buy-out funds, which present their financial statements on a fair value basis as required by the *AICPA Audit and Accounting Guide for Audits of Investment Companies Guide*,

these policies are not always applied consistently. Usually such valuation policies recognize the lack of liquidity in fund investments. In cases of less liquid or other non-traditional private equity investments, cost is generally a proxy for value unless significant market events occur subsequent to acquisition or there are clear indications that value has declined.

Many partnership agreements, including those of private equity security funds, provide that the sponsors should determine the fair value of portfolio investments. These values may or may not be subject to approval of a limited partner advisory committee or board or other advisory group.

In the case of real estate funds' stabilized and post-event assets, the properties generally are leased up and generating cash flows, or an event has occurred that is clear evidence of the future cash flows or comparables are available for valuing such assets. Many value the asset on an "as-is" condition. This reflects the condition and status of a property as of a specified date, taking into consideration the potential for increased financial performance, completion, construction, renovation, and management change or lease-up, and recognizing the risks associated with achieving improved performance. Assumptions differ for rental housing, office, industrial, retail, and hospitality assets. Tenants' terms and lease conditions, rent-up provisions and cap rates are materially different. Local markets differ from one another.

For non-stabilized assets, establishing value is much more difficult. The challenge with these assets is that estimating fair value at any given point during the holding period is much more subjective than with stabilized assets, as the ultimate realization of value depends greatly on the sponsor executing its value-enhancement and exit strategy. And there are very few comparables. Furthermore, value creation often depends on variables such as the sponsor's identifying the right buyers for unique investments and correctly timing the market.

Similar challenges exist in valuing development assets and land held for development. In many situations value may not be created or cannot be valued until the project is done, the lights are on, and the property is up and operating. Therefore, cumulative costs must be continuously evaluated to determine if the asset's value is less than cost or if reserves are needed.

In cases of unzoned land held for development and land under development there are additional challenges. First, since many regulatory, political, financial, and other uncertainties surrounding the land holding and development process — for example, whether entitlements will be obtained, and under what conditions, or whether project financing will be

approved, and on what terms — the valuation of land at a particular time is difficult. Second, as uncertainties exist in the land holding process and in development, construction, and lease-up, the most useful reporting for investors is a cost and progress report covering activities such as approvals, zoning, and building permits that could result in measurable enhanced value. Third, because the valuation of these investments at any given point in the holding period is highly uncertain, opportunity funds tend to state the fair value of such investments at or approximately at cost, until a realization event occurs or is imminent. We believe that this methodology is not only acceptable but is appropriate for such assets.

REPORTING

What matters is not the value of the fund's investment portfolio at a given point but its return on those investments, measured on a risk-adjusted basis as well as on a cash basis. However, risk evaluation is highly subjective.

Most funds view IRR as the most appropriate performance measure. Some go further, suggesting that projected IRR, including the expected residual value, is the best proxy for interim measurement of performance. Performance measurements for real estate are provided by the Association of Investment Management and Research (AIMR) — which provides for both IRR and Time-weighted Returns (TWR). Most real estate private equity funds currently report only gross projected IRR. Venture Economics, provides for an annual IRR calculation using actual monthly cash inflows and outflows to investors. Its benchmarking incorporates residual values reported in the annual financial statements. Separately, the American Institute of Certified Public Accountants issued new guidelines (effective for years ending December 31, 2001) on reporting financial highlights, including a TWR.

TWR is calculated as the geometric mean of the rate of return between two or more periods, multiplied together geometrically. As is well known, TWR is a misnomer because it does not consider the time value of money. Specifically, it treats a dollar distributed today the same as a dollar distributed nine years ago, yielding a metric that fails to penalize for timing decisions and could distort results. TWR is most often used in instances where managers have no control over the time of cash in and out of their management. This is clearly not the case with real estate private equity funds. As a result, most sponsors appropriately do not give TWR much weight.

After long debate, accountants generally agree that in reporting to the public and the SEC, the only consistent methodology is the lower of cost or mar-

ket on a historical cost GAAP basis (or, in some instances, a modified basis), with cost being the dominant approach. The problem is that while cost is easily definable, it does not reflect the current value of a company's assets or liabilities. Under historical cost GAAP, public companies and their accountants are required to address valuation issues when the market value is lower than the cost. To meet this requirement, companies annually take current assets including land and development projects held for sale (such as for-sale or multifamily housing) and apply a net realizable methodology (current market less cost to dispose). In the case of long-term assets, companies look at long-term or permanent impairment. This approach is very similar to a methodology recently issued by the Financial Accounting Standards Board, concerning the handling of good will in purchase accounting. Companies now carry good will at cost but continuously test for current value to determine if an impairment occurred and should be written down (but not up).

Other valuation methodologies have been developed over the years. For example, Ernst & Young created the DIV (derived investment value) methodology for valuing assets of the RTC. This methodology has been modified to value non-performing loan portfolios held by banks in Japan and other countries in Asia by factoring in litigation and bankruptcy assumptions.

What is clear is that the practice of reporting the lower of cost or market methodology is not appropriate for measuring the comparative performance of opportunity funds. Alternatives need to be considered that would address the following questions (and focus on expanded reporting): What are the goals and objectives of the fund, its investors, and the sponsor? What is the fund's strategy? What are the key risks and complexities of the asset? Are investors subject to major events or external factors that might have an effect on the fund's performance? Are they looking to get interim measurements with respect to some form of mark-to-market? What is the exit strategy (sale, refinance, strategic alliance, trade)?

RECOMMENDATIONS

The wide variation in reporting practices among opportunity funds clearly demonstrates a need for greater transparency and consistent standards across funds and sponsors. The underlying questions are: first, whether all funds should report on a fair value basis; and second, whether a single value and measurement methodology should be adopted in the interests of consistency. Our belief is that the fair value approach with expanded reporting should

be adopted, and a framework should be developed with some standards and guidelines along the following (because of the nature, complexity, and dissimilarity of funds, complete comparability may not be achieved, but the guidelines will help investors evaluate if funds are performing as they planned):

- Detail quarterly and annual overviews of investment activity and fund performance in terms of progress on the particular properties and changes in status from period to period, including commentary on major actions, events ,and conditions that have changed (for example, market conditions, status of construction progress, lease-up status, zoning and entitlement, and regulatory issues).
- In quarterly and annual narratives, describe the activity and performance of each fund investment compared with the strategy and the underwritten IRR.
- Prepare a special events report — similar to an 8K for public companies — reporting unusual events when they occur.
- Publish quarterly and annual summaries of cash inflows and outflows. Investment vital statistics should include condensed financial information for each fund investment.
- Fully detail and update all activity related to debt or leveraged components of the investment, debt in including underlying ventures in partnerships and compliance with underlying loan provisions and covenants.
- Group quarterly reports on the performance of fund assets according to the following categories: assets sold; stabilized assets that are ahead of acquisition underwriting; stabilized assets on target with acquisition underwriting; stabilized assets that are below acquisition underwriting; and non-stabilized assets.
- For each of these groupings, we recommend that, at a minimum, the sponsors report: the asset name; date purchased; cost; equity invested; reserves; debt level; ownership percentage; NOI (when relevant); current value (when relevant); IRR (when relevant); and equity multiple (when relevant).
- For non-traditional types of investments, include details about changes in market conditions, regulatory bodies, restrictions, or limitations.

Projections have long been used by accountants as a tool in the valuation and evaluation of assets on the balance sheet — whether testing for market impairment or lower of cost or market for assets held for sale. We believe these should be adopted in the reporting, consistent with management's responsibility of setting forth its plan, all of its assumptions, cash flows throughout the holding period, and the projection of the future value of the residual.

Our recommendations for measurement are:

- Perform calculations on an individual asset basis as well as on a fully rolled-up consolidated basis.
- With IRR calculations, use the projected residual value methodology where stabilization has occurred.
- Carry non-stabilized investments at cost and test for impairment on a quarterly basis.
- Perform all calculations on a gross IRR basis as well as a net IRR basis after taking into consideration the fund expenses, including management fees and net carried interest of the fund sponsor.
- Perform all calculations applying GAAP accounting rules and with respect to consolidation of partnerships, joint ventures, and non-wholly owned corporations, and essentially consolidating where effective control exists.
- Provide multiple performance calculations including: cash on cash returns from inception to reporting date; cash on cash returns from inception to date of exit; IRR using the projected residual value methodology; and equity multiples.
- Assess whether each fund investment is tracking on, below, or above the underwritten IRR, and why.
- For the same time period, the time weighted return analysis should be an optional reporting method, if the investor desires it. Because it is not an accounting methodology, it should be based on existing AIMR or NCREIF standards.
- Whatever methodologies are used — and more than one may be appropriate — they should be applied consistently across all funds and sponsors.

We believe that if the sponsor is unwilling to state the current value of stabilized assets, then investors should seriously question investing in their funds. We see little, if any, value added by sponsors engaging in formal appraisals, as we believe that sponsors generally understand the value of these assets far better than appraisers.

Finally, we recommend that all unimpaired non-stabilized assets be carried at cost, because, for these assets, it is simply too soon to ascertain whether the opportunity to create value will be realized. However, in the detailed asset descriptions for these properties, it is critical for the sponsor to describe the progress and hurdles facing these assets.

ROLE OF ACCOUNTANTS

Some in the private real estate equity fund industry believe that accountants can assist with the development of standards and the valuation process, and that they can help the industry's development of better reporting, standardization, and best practice dis-

closures. The result could be a sector that provides more transparent, consistent, and complete disclosure that enables investors to evaluate the performance of funds and their portfolios and hence make better-informed investment decisions. The funds, too, would benefit from having a clearer picture of their investments, portfolio performance, and operations. The valuation process would then serve as more than a report card on fund performance; it would also function as an important management tool for opportunity funds as they continue to grow, diversify, and expand.

THE FUTURE

Many investors ask whether there will be a role for real estate private equity funds in the global real estate market. The answer is a definitive yes. The real question concerns what role funds will play. The U.S. real estate market is roughly $5 trillion, and the European and Japanese markets are approximately $6 trillion to $8 trillion. In markets of this size, there will always be selective opportunities to achieve attractive risk-adjusted returns. This is particularly true given that the relatively steady cash streams available on real estate lend themselves to the LBO strategy.

It is very important for both sponsors and investors to remember that there will be periods when markets will offer relatively few attractive investment opportunities, while at other times opportunities will be plentiful. Prudent sponsors will realize that attractive investment opportunities will be available over the life of the real estate fund. Thus, the question is not whether there are opportunities, but rather whether the sponsor is sufficiently disciplined to find and take advantage of the greatest opportunities.

Although the real estate private equity vehicle is a notable improvement over previous investment vehicles available to private real estate investors, investors must be aware that, just as the safety features of a car are extremely important, a bad driver is at serious risk in any car. Real estate private equity funds are only as good as their sponsors. Therefore, investors must continually monitor their fund sponsors and managers in order to assure that they are getting what they deserve. An effective way is to require that fund sponsors invest substantial amounts of their own capital in their funds. While this does not eliminate perverse incentives or guarantee successful performance, it does provide great comfort to know that the sponsors have substantial amounts of capital at risk in their funds. This, combined with standardized and detailed reporting, will assure that the real estate private equity vehicle will be around for a long time.

As a possible next step, a task force representing the major real estate private

equity funds could be created to further develop a fair value approach to reporting, guidelines, supplemental reporting, reporting for non-stabilized assets, and the definition of stabilized assets and other issues. The task force must have the full support of funds, sponsors, and investors and it should serve on a continuing basis. Based on our preliminary discussions with leaders in the opportunity fund industry, there appears to be strong support for this idea. The task force might develop the equivalent of the AIMR performance and presentations standards handbook. Alternatively, it could agree that only general guidelines should be promulgated; at a minimum, however, all funds would have to expand disclosure and show some IRR calculations and equity multiples. The point is that absent a performance benchmark, the burden falls on funds and sponsors to inform investors.

From their early beginnings more than a decade ago, real estate private equity funds have become a permanent part of the investment landscape, with a promising future. With that certainty and predictability comes a large responsibility: to provide transparency and consistency in the reporting process and to develop performance standards. If funds take the initiative in meeting investor expectations, they will play a large role in shaping their future. If not, their future will be determined by the divergent forces that are pressing for changes in the industry's reporting practices. It's time for fund sponsors to step up to the challenge.

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