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FEATURES

DEPARTMENTS

Making the Grade

Investors Continue Their Search for Accurate and Timely Valuation and Performance Measurements

by Tyson Freeman

The art and science of analyzing the performances of real estate assets, portfolios and investment managers continues to be a work in progress. While the process is still imperfect, investors and consultants are fine-tuning their performance benchmarks and measurements to better match the make-up and investment strategy of respective portfolios. Measuring performance at the high-yield end of the spectrum is even more challenging; however, new indices are in the works.

One of the longest running set of issues facing real estate as an asset class centers on measuring and comparing performance. Real estate portfolio performance will never be tallied and analyzed in the same way as public equities or bonds. But consultants and general partner investors have continually urged more consistent valuation and reporting methods as well as more realistic benchmarking.

"These are ongoing issues and, unfortunately, there is not as much of a scientific answer, or ingrained system in place, as we [consultants] would like to see," says Allison Yager, principal – real estate research at Mercer Investment Consulting. "But there has been some encouraging progress."

One interviewee would not divulge names but said several of the firm's clients have changed their valuation methods over the past two years. And there is a feeling on the part of many consultants that recent efforts to improve benchmarks will be accepted by much of the industry.

As the institutional market has grown steadily from a relatively inefficient market driven by local knowledge and proprietary information to a more sophisticated data-driven industry with a burgeoning public market, pension investors have grappled with how to standardize at least some of the measures used to analyze real estate portfolios.

The push for improved benchmark and performance measures is also being driven by investors' increasing exposure to traditionally opaque and hard-to-measure sectors such as opportunistic or emerging markets.

"It is moving more slowly the more you move to opportunistic investments, but there is an increasing amount of attention paid to judging performance more frequently as more investors continue to get their arms around real estate as an asset class," says Frank Blaschka, principal at The Townsend Group.

"Private real estate investors have increased allocations to more value-added, opportunistic and international investments. Even REITs are going global," adds Denise Chan, senior

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vice president at Pension Consulting Alliance. "With so much capital flowing to these types of markets, there is a very real need to understand and measure risk better."

ANALYZING ASSET-LEVEL PERFORMANCE

Analyzing a portfolio's performance starts with the assets that comprise the fund(s). Obviously this is a far different and more complicated task than assessing performance of stocks in an equity portfolio. But consultants say that given the increasing sophistication of investors and the ultra-competitive real estate investment market, getting a better handle on the task should be a priority.

"Property-level reviews are definitely important," says Yager, "Especially in this market where there is a lot of money chasing deals."

Yager says property-level analyses conducted by asset managers on a quarterly basis are normally compared to budgeted expense and revenue numbers and leasing expectations. What the analysis also should emphasize, she says, is the property's investment performance versus pro forma and current market conditions.

"Ongoing reviews are done on the property level at least quarterly, but we also like to see portfolio-level analysis," says Yager. "Portfolio-level analysis can provide additional insight for managing risks and creating value opportunities. We are continually trying to assess the relative risk exposure of each fund."

Yager says there is a wide range of how detailed firms get with this analysis. "The quality of this analysis varies, but it is starting to evolve. I've seen increasing signs of a shift where analysis and evaluation of a portfolio includes an analysis of risks and is reviewed by a committee of senior members of the firm. That is the type of approach we believe is beneficial."

Yager has begun to research how various core funds approach performance review and measurement, and she states it is difficult to discern the best practice since there are so many moving parts that affect performance and because of the lack of an auction process such as in the public equity and bond markets, which would provide a constant flow of information.

"As much as we would like this process to be more scientific, it is difficult because of the lack of consistent information," notes Yager. "There is a substantial amount of quantitative data to review, but there are also the qualitative data points to consider."

This reality can sap energy from the argument that investment managers must dedicate more time to performance assessment. The assumptions that are necessary for arriving at a valuation for a redevelopment project are just one example. (Is the future demand plausible? Are market rents going to continue to rise? Are these building expenses realistic?)

VALUATIONS … A STICKY POINT

Historically, the methods and the frequency of conducting valuations for assets, whether they are part of a strategic analysis or solely for reporting requirements, have ranged widely for different investment strategies and among different firms. Precisely how firms value their portfolios is also an ongoing issue in the industry, one that is worthy of its own discussion.

Here again, there is a fairly wide variety of approaches, though less so than in the past, note the consultants. "For core funds this info is relatively widely available now without spending a lot of time and money," says Blaschka. "It is much harder to get this type of information for value-add and opportunistic portfolios."

Consultants generally agree that conducting more regular valuations, particularly third-party valuations, regardless of methodology, would be a positive development.

Most core properties, says Yager, are valued quarterly and, while the managers do not conduct the appraisal, they are aware of the assumptions being made and the need to support the conclusions of the resulting valuation. This, she says, serves as a fairly effective system of portfolio assessment; however, there always will be a need for rigorous analysis and re-evaluation of the process because of the lack of a consistent flow of information.

As the investment styles migrate from core, however, the adopted valuation methods vary more across firms.

According to Blaschka, Townsend's noncore clients' portfolio assessments take place periodically as part of the reporting function. While there is quarter-to-quarter analysis of performance, limited weight is placed on any single quarter because there can be extreme variability in many of the noncore funds underlying investing situations. That variability can take the form of a large, one-time expense or lease rollovers or the initial outlays for a development project. Some argue that there are just too many factors portfolio-wide for such frequent valuations to be useful.

"But investors, their consultants and the funds' own management are still looking for trends and comparing returns to their expectations," says Blaschka The failure to meet expectations, even if modest, can be a sign of underlying problems and issues that merit greater scrutiny. "Many investors place funds on so-called 'watch lists' for performance issues, for personnel turnover or when there has been a recent sale of the firm and there is new management."

And there appears to be a begrudging and very recent shift to incorporating more third-party appraisals. "Domestic noncore private equity–oriented funds are increasing the frequency in the use of outside appraisals," observes Blaschka. "Since these funds often are developing assets or repositioning vacant projects, however, there is still a lot of imperfect information being used as part of the valuation process."

Blaschka says valuation and performance measurement methods at the higher return or opportunistic end of the spectrum are improving some, but there is still a lot of variability between firms.

"There used to be a lot more variation in how and how often these measures were taken in the opportunistic realm," agrees Jamie Shen, senior vice president and head of real estate consulting at Callan Associates. "Generally we see more marking to market than we used to there."

"It is still often very challenging to get access to that type of [appraisal] info," adds Chan. "In part, you have the real challenge of providing information when they are doing joint ventures or more structured deals. And those do not lend themselves well to analysis. And it is always a function of how much managers are willing to do."

"When investors are buying into Colony- or Blackstone-style private equity vehicles, it is much, much harder to value the underlying assets and analyze how current portfolios are performing," says Blaschka. "There's still a long way to go in improving valuation and assessment of these portfolios, particularly for the offshore funds. But it is getting better and will continue to get better."

Blaschka says the market will see better metrics and measures as well as improved transparency as money continues to flow into global markets and as publicly traded real estate vehicles begin to catch on in other regions of the world.

"You have a CMBS market growing globally, which is driving some relatively new information on risk and return," notes Blaschka. "That info will be very useful in getting a better handle on some of the markets, as will the increase in the growth in publicly traded real estate equity securities."

But today's market environment is not necessarily conducive to plan sponsors applying too much pressure to investment managers for more information. In an environment where there is so much liquidity, investment managers are raising capital for a new fund even before their previous fund has posted any performance results.

"There is often no meaningful return information on newer funds," states Blaschka. "A firm can be raising Fund VI and there are still five or six years until we see Fund V perform. Investors often must make a decision on projections. We are spending more time looking at new assets and digging into asset-level information on many occasions to obtain a better understanding of those projections."

BENCHMARKS … HOW USEFUL?

Assuming a valuation and data collection scheme can be agreed upon, what will the portfolio's performance be compared to?

The options are limited and the industry generally turns to the National Council of Real Estate Investment Fiduciaries Property Index (NPI) as the go-to asset-level index. The limitations of the NPI are well known by most in the industry, but for point of reference for a single asset's performance, it is really the only game in town.

Most times, however, comparisons to the NPI alone are not sufficient to red flag a property's or manager's performance. Comparison to benchmarks is only half of the comparison. The other half is how the managers are performing against other managers.

"We feel NCREIF has done as good a job as any in creating a property-level benchmark," says Shen. "But when we benchmark clients' assets against NPI, we also use our proprietary database to look at the portfolio returns at the investment level. This incorporates typical debt levels and deal costs and the other administrative costs of running the portfolio."

Shen notes the investment managers that participate in Callan Associates' database report data on a quarterly basis, and the total universe of the database can be split into different investment strategies to create more useful indices. For example, the universe of core-focused funds can be extracted and split into separate accounts and commingled funds. A similar process can be followed with value-add and opportunistic strategies.

"[The process of building a timely database] has been more of a challenge for opportunistic funds because there is often a lag in getting the information, or there are joint venture partners and the information just doesn't flow up as easily," says Shen.

Chan adds that PCA is also working on a way to improve benchmarking capabilities for noncore strategies. "There really isn't a benchmark for opportunity-style funds and international markets. So PCA has gathered data on opportunity and value-added funds since 2000 and published a white paper on the results. We are preparing a survey for an update."

Plan sponsors are tweaking these benchmarks as the improved ones become available and as the makeup of their portfolios shifts. In 2006 The Regents of California made some changes to the benchmarks it uses in assessing its real estate portfolio. The changes were outlined in an August 2006 Investment Plan document for the real estate allocation for the retirement (UCRP) and endowment (GEP) plans. Under the original real estate investment plan guidelines, private real estate investments were measured against the NPI. Under the new plan, the Treasurer suggested the performance of the Enhanced and High Return allocations be measured first as internal rates of return, and secondly, that those returns be compared to a universe of similar strategies compiled by The Regent's real estate consultant, which, in this case, was Townsend.

Once the entire equity real estate portfolio is fully-invested and mature, the Treasurer suggests that performance of the total private real estate allocation be measured against the NPI.

Public real estate investments are to be measured against the Dow Jones-Wilshire REIT Index. With the potential allocation of capital to global REIT markets, however, it was proposed that global REIT managers would be benchmarked to the FTSE EPRA/NAREIT Global Real Estate Index, while continuing to use the Dow Jones REIT Index domestically. The entire REIT portfolio would be benchmarked to a weighted combination of the two.

Shen believes the improvement in benchmarking is real. "I might be in the minority, but the industry had already come a long way on this," she says. "The amount of info is much better than just five years ago."

NCREIF also has been at work on creating additional benchmarks to cover a wider range of investment structures and strategies. In first quarter 2005, NCREIF published the first in a series of Fund Indices. The NCREIF Fund Index – Open End Diversified Core Equity (NFI-ODCE) is now being published on a quarterly basis.

"If you are analyzing open-end core commingled funds, people are starting to look to NFI-ODCE. For the first time we have an investable benchmark in real estate," states Blaschka.

"I think you will see more investors adopting that index for their core program or even using it as a way to evaluate value-add by adding a basis point adjustment for different levels of risk," adds Blaschka. "Some of these are relatively crude measures, but right now people are inclined to use the NPI or NFI-ODCE and add basis points to benchmark value-add, opportunistic or emerging market returns. It works better for U.S.-oriented investments, as recent data on international investing shows a lower correlation with the U.S. markets."

MORE INDICES ON THE WAY

Soon there will be other benchmark options for plan sponsors to turn to. Kevin Lynch, a principal and co-founder of The Townsend Group, says the firm was selected by NCREIF as a global provider of performance data for the new commingled Core, Enhanced and High Return (aka opportunistic) sector indices. Lynch says that sometime in 2007 plan sponsors will be able to compare how well their managers compare to an index of like strategies.

The NFI-ODCE, an index of investment returns reporting on both a historical and current basis, is comprised of 26 open-end commingled funds that pursue a core investment strategy. Some of the participating funds have performance histories dating back to the 1970s. The index is cap-weighted and reported gross of fees. Measurement is time-weighted. The next index in this series will be an All Open End Fund Index, which is expected to be released shortly, followed by indices for closed-end and opportunity funds.

"When all is said and done, there will be over 800 funds, a pretty comprehensive database with solid historical data," notes Blaschka.

That does not necessarily mean the indices will be quickly adopted. All interviewees expected the benchmarks would be adopted in time, but not overnight. There are reasons these practices are adopted slowly. Theoretically, the reasons for accepting them are sound. But the movement away from legacy methods is normally a slow one, says Blaschka.

"And, quite honestly, some of these benchmarks, especially the open-end benchmarks, are harder to beat than what the industry has used in the past," adds Blaschka. "From a staff investment officer's viewpoint, if your compensation is tied to the benchmark and that benchmark is now more rigorous and harder to beat … that friction might slow adoption, not in a major way, but it is one of the factors."

A WORK IN PROGRESS

As the institutional real estate marketplace has shifted from a relatively inefficient market driven by local knowledge and proprietary data toward a more sophisticated, data-driven industry with a burgeoning public market, the asset class is evolving to resemble its more-established equity and bond cousins. Of course, there are unique attributes that still shape this private market and provide challenges for investors. Measuring and comparing investment performance will continue to prove challenging for investors. The industry is working to develop more sophisticated methods of measuring performance in order to improve the ability to evaluate and manage assets, portfolios and investment managers. There has been progress, particularly with regard to benchmarking, but most agree there are still many reaches of the real estate market, especially high-yield and global investment strategies, that remain difficult to measure. ❖

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NPI and NFI-ODCE Compared (as of 6/30/06)

	NPI	NFI-ODCE
Composition	Properties	Private open-end funds
Leverage	Reported with no leverage	Not more than 40% (6/30/06: avg. 20%)
Joint Ventures	Reported on 100% ownership basis	Reported in net terms consistent with accounting treatment
Cash Balance	No cash	Includes cash balances
Size	$220.8 billion assets (5,055 properties)	$73.2 billion gross real estate assets; $58.7 billion net real estate assets (1,497 properties)
Property Types	Apartment, hotel, industrial, office, retail	At least 80% of real estate assets in these types
Geography	U.S.	At least 95% in U.S. (6/30/06: no non-U.S. properties)
Diversification	Not specified	Not more than 70% in one property type or one region
Management Fees	Not meaningful	Indexes for gross of fees and net of fees performance
Strategy	Various. Excludes properties in initial lease-up	Diversified core equity

Sources: NCREIF, INVESCO Real Estate, Prudential Real Estate Investors