4-10 GUIDANCE STATEMENT ON REAL ESTATE

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Retroactive Application: Not Required

Introduction and Scope

The real estate provisions in Section 6 of Chapter I of the Global Investment Performance Standards apply to

- wholly owned or partially owned properties;
- real estate commingled funds, separate accounts, and unit trusts;
- unlisted, private placement securities issued by private real estate investment trusts (REITs) and real estate operating companies (REOCs); and
- equity-oriented debt (e.g., participating mortgage loans) or any private interest in a property where some portion of return to the investor is related to the performance of the underlying real estate assets.

Real estate includes land, buildings under development, completed buildings, and other structures or improvements held for investment purposes.

The real estate provisions apply irrespective of whether a real estate investment is producing revenue and also apply to real estate investments with leverage (gearing).

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 applicable general provisions of the GIPS standards. The general provisions that do not apply to real estate composites are noted parenthetically within Section 6 of Chapter I of the GIPS standards.

The following investment types are not considered real estate investments and, therefore, must follow Sections 0–5 in Chapter I of the GIPS standards:

- publicly traded real estate securities;
- mortgage-backed securities (MBS, CMBS); and
- 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.

The following guidance includes a discussion of issues relating to real estate investments.

Investment Discretion

The GIPS standards require that all actual, fee-paying, discretionary portfolios be included in at least one composite. Discretion is the ability of the firm to implement its intended strategy. Each firm must document its definition of discretion and must apply the definition consistently. As stated in the Guidance Statement on Composite Definition, there are degrees of discretion and not

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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 firm's definition of discretion must include criteria such that if the firm has sole responsibility or sufficient decision-making authority for major investment decisions, the real estate portfolio must be considered discretionary. Major decisions include, but are not limited to, determining the investment universe, acquisitions, dispositions, investment structuring, financing, capital improvements, leasing, and operating budgets. In some cases, client-imposed restrictions may result in some decision-making authority being retained by the client. However, if the firm has sufficient decision-making authority to implement the intended investment mandate, objective, or strategy, the portfolio should be considered discretionary.

The following is an example of a discretionary portfolio:

- The firm, without client approval, makes all acquisition, investment structuring, financing, leasing strategy, capital expenditure, and disposition decisions and, therefore, can fully implement its investment strategy. This is often the case for products sponsored by the firm, such as real estate pooled or commingled investment fund vehicles.

The following are examples where the firm may be able to characterize the portfolio as discretionary, consistent with its definition of discretion:

- The firm, without client approval, makes all acquisition, investment structuring, financing, leasing strategy, capital expenditure, and disposition decisions so long as the firm does not exceed specified thresholds agreed to with a non-pooled or non-commingled investment vehicle client.
- The firm retains control over property management (day-to-day operations); makes strategic acquisition, investment structuring, financing, leasing strategy, capital expenditure, and disposition recommendations; and is not required to but typically does obtain client approval for these items prior to transaction execution.

The following are examples where, in most instances, the firm would characterize the portfolio as non-discretionary, consistent with its definition of discretion:

- The client has complete investment discretion regarding real estate investments.
- The client prohibits or significantly limits repositioning of the portfolio through dispositions.

Composite Construction

One of the key principles of the GIPS standards is the presentation of composite performance, where a composite is defined as an aggregation of one or more portfolios managed according to a similar investment mandate, objective, or strategy. The real estate provisions of the GIPS standards embrace the notion of composite-level reporting. Real estate investment management firms are required to present performance in composites defined by investment mandate, objective, or strategy. Real estate closed-end fund composites must be defined by vintage year and investment mandate, objective, or strategy, and the composite definition utilized must remain consistent throughout the life of the composite. The vintage year concept is an important factor for real estate

closed-end fund composites and could potentially limit real estate closed-end fund composites to one fund per composite because firms are unlikely to raise another fund with the same strategy in the same vintage year.

Users and recipients of real estate performance frequently request only an aggregation of property-level performance, which is not consistent with the composite construction principles of the GIPS standards, which are based on investment-level performance. Although firms are not prohibited from presenting property-level performance outside of a compliant presentation or as supplemental information to a compliant presentation, firms are required to make every reasonable effort to provide a compliant presentation to all prospective clients. Please see the Guidance Statement on the Use of Supplemental Information for further information.

The term "investment level" is intended to reflect the impact of ownership and financing structures and includes all underlying property-level activity. Investment-level returns are distinct from property-level returns, which exclude all of the non-property (investment-level) balance sheet items as well as income and expenses. Property-level returns include only those income and expenses that directly relate to operating the property.

A real estate investment management firm may be asked to provide an aggregation of historical performance by property type, which is much narrower than any of the broader investment strategies managed by the firm. For example, the firm may be asked to provide investment performance consisting of only its office building investments, which requires extracting the performance of all office building investments from its broader real estate investment strategies. Such an aggregation is not a composite. This performance can be shown outside of a compliant presentation or as supplemental information to a compliant presentation. If the aggregation is representative of a distinct investment strategy, the track record of the narrower mandate may be able to be presented as a carve-out. Please see the Guidance Statement on the Treatment of Carve-Outs for further information.

For periods beginning on or after 1 January 2011 (for periods ending on or after 1 January 2011 with respect to since-inception internal rate of return), the composite construction requirements for real estate closed-end fund composites mandate that closed-end real estate funds, if any, be in separate composites. The real estate provisions of the GIPS standards contain additional requirements and recommendations specifically for closed-end fund composites. In addition to creating separate composites for closed-end real estate funds, provided all composite construction requirements are adhered to, a firm may choose to include open-end and closed-end real estate funds in another composite because firms are permitted to include a portfolio in more than one composite. If a firm includes both open-end and closed-end real estate funds in a composite, the firm must follow the general real estate provisions (those that are not specific to closed-end fund composites) with respect to this composite and should consider disclosing the types of portfolios included in the composite as part of the composite description. Please see the Guidance Statement on Composite Definition for further information on composite construction.

Inclusion of Portfolios in Composites

The GIPS standards state that composites must include new portfolios on a timely and consistent basis after each portfolio comes under management. When computing time-weighted rates of return, a "partial period" or "stub period" can occur for the period from a portfolio's inception up

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to the beginning of the first full period when a portfolio is placed into the composite. A question that often arises is whether it is proper to reflect stub-period portfolio performance in the calculation of the time-weighted composite performance.

Historically, firms have used different approaches to address the partial-period issue. The nature of the real estate asset class is unique, and it is often composed of illiquid investments with infrequent acquisition and disposition activity. When calculating time-weighted returns for periods beginning on or after 1 January 2011, it is recommended that real estate composites include new portfolios on the portfolio's inception date, which is typically the date of the portfolio's first external cash flow.

Similarly, the GIPS standards state that terminated portfolios must be included in the historical performance of the composite up to the last full measurement period that each portfolio was under management. When computing time-weighted rates of return, a partial period or stub period can occur for the period from the last full period a portfolio is included in a composite to the portfolio liquidation date. When calculating time-weighted returns for periods beginning on or after 1 January 2011, it is recommended that real estate portfolios remain in composites as long as they are invested according to the composite strategy. If the client terminates the portfolio and divesting begins, the portfolio should be removed from the composite as soon as it no longer reflects the composite strategy due to the liquidation.

Each firm must document its policies and procedures for inclusion of real estate portfolios in composites and must apply these policies and procedures consistently. For periods beginning on or after 1 January 2011, firms must disclose in each real estate compliant presentation their policies for inclusion of real estate portfolios when calculating time-weighted returns. For periods beginning on or after 1 January 2011, firms should disclose any time period differences between the composite and the benchmark.

Fees and Expenses

When calculating returns, the following guidance must be used to determine how real estate investment management and other fees and expenses are treated.

Gross-of-fees and net-of-fees returns must be net of all property-level expenses. Property-level expenses are those that directly relate to the operations of the property. Gross-of-fees and net-of-fees returns must also be net of debt service, including preferred equity dividends.

The difference between gross-of-fees and net-of-fees returns should reflect only investment management fees that the firm charges for providing investment management services. Investment management fees typically include a recurring base management fee (often calculated on the basis of invested or committed capital), a performance-based fee (carried interest), and certain types of transaction-based investment management fees.

Fees and expenses must be evaluated to determine their proper treatment when calculating returns. Firms are required to deduct actual transaction expenses incurred during the period when calculating both gross-of-fees and net-of-fees returns. Acquisition, disposition, and financing services performed by the firm, an affiliate of the firm, or a third party on a particular transaction are considered "transaction expenses" and must be deducted from both gross-of-fees and net-of-fees returns. These transaction expenses (also referred to as "brokerage expenses") are direct costs incurred upon implementation of a particular investment transaction and are considered true transaction expenses. If any of these transaction services are performed by the firm or an affiliate of the firm, a description of such services performed by the firm or affiliate should be disclosed in the compliant presentation.

Please note that the true acquisition and disposition transaction expenses described above are different from investment management fees specifically associated with acquisition and disposition services performed by the investment manager. It is common practice in the real estate industry that investment management agreements separate the investment management fee into one or more of the following components: base investment management, acquisition, disposition, and financing. In this scenario, the fees specifically relating to acquisition and disposition are typically considered to be part of the investment management fee because they relate to the investment management responsibilities performed by the firm in formulating its investment decisions as part of the normal investment decision-making process. Please also note that financing fees, if applicable, are typically identified separately in the investment management agreement and are classified as transaction costs because they are usually related to post-acquisition refinancing.

Investment-level administrative costs are not required to be deducted from gross-of fees or net-of-fees returns. In many jurisdictions, however, it is common practice in the real estate industry to deduct such items when computing gross-of-fees and net-of-fees returns. When presenting gross-of-fees returns, firms must disclose if any other fees are deducted in addition to the transaction expenses. When presenting net-of-fees returns, firms must disclose if any other fees are deducted in addition to the investment management fees and transaction expenses. If the investment-level administrative fees and expenses include services performed by the investment management firm or an affiliate of the firm, a description of such services performed by the firm or affiliate should be disclosed in the compliant presentation.

Determining the Non-GIPS-Compliant SI-IRR Performance Period for Real Estate Closed-End Fund Composites

The GIPS real estate provisions require that real estate closed-end fund composites present the net-of-fees since inception internal rate of return (SI-IRR) of the composite through each annual period-end in the compliant presentation. When coming into compliance, firms must initially present at least five years of performance (or for the period since the firm's inception or the composite inception date if the firm or the composite has been in existence less than five years) that meets the requirements of the GIPS standards. Each subsequent year, firms must present an additional year of performance. Furthermore, firms must not present a non-GIPS-compliant SI-IRR for periods ending on or after 1 January 2006. However, firms may present a non-GIPS-compliant SI-IRR for periods ending prior to 1 January 2006 provided that only GIPS-compliant performance is presented for periods ending on or after 1 January 2006. For any SI-IRR performance presented for periods ending prior to 1 January 2006 that does not comply with the GIPS standards, firms must disclose the periods of non-compliance.

The measurement period for an SI-IRR is the period from the inception date of the investment vehicle and/or composite through the end of the period that is being reported. Please note that the term "since inception" is independent of the calculation method used. For example, it is possible to calculate a "since inception time-weighted rate of return." Although it is not required or recommended in the GIPS standards, it is also possible to calculate an IRR between any two points in time within an investment period that is not necessarily since inception.

In a "since inception" IRR calculation, the beginning date remains constant and does not change. The measurement period for an SI-IRR becomes increasingly longer as the ending date is extended, whereas the beginning date is constant. A TWRR, as typically disclosed in a compliant presentation,

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does not have a constant beginning date like an SI-IRR but, rather, it is a mathematical linking of several interim independent sub-periods. Conversely, an SI-IRR has one measurement period — from inception to the end of the period being measured, with no linking of interim independent sub-periods.

It is necessary to use the period-end date of an SI-IRR to determine the non-compliant time period. For example, if a firm claims compliance with the GIPS standards beginning 1 January 2006 and the real estate closed-end fund composite history begins 1 January 2003, an SI-IRR is required to be presented from 1 January 2003 (inception) through each subsequent annual period starting with the period ending 31 December 2006 (assuming a calendar year-end period). If this firm chooses to present an SI-IRR through periods ending prior to 1 January 2006, these performance periods must be disclosed as non-compliant.

Effective Date

The effective date for this Guidance Statement is 1 October 2012. When bringing past performance into compliance, firms may comply with this version of the Guidance Statement or with prior versions that were in effect at the time. Prior versions of this Guidance Statement are available on the GIPS standards website (www.gipsstandards.org).