NCREIF PREA
Reporting Standards

Exposure Draft

IRR Reporting for closed-end funds: Providing transparency, comparability and relevance to Internal Rate of Returns ("IRR" or "IRRs"), gross of fees and promote, net of fees and promote

EFFECTIVE DATE: FOR FISCAL YEARS BEGINNING AFTER DECEMBER 15, 2019 WITH EARLY ADOPTION ENCOURAGED

Invitation to comment: September 10, 2019 through November 8, 2019

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Executive Summary

Overview

IRR is perhaps the most widely accepted performance measure relied on for strategic decision making for closed-end funds, whether it is being reported for the fund's portfolio or for the investors, (in either case over a relevant holding period(s)). Often specified in legal documents are target IRR expectations, both in terms of potential investments that are promising enough to be considered, as well as in terms of what IRR an investor might hope to achieve when the fund has ended. Comparisons among targeted, projected, and actual IRRs are commonplace (though not contemplated in this paper), and it is critical to ensure that these are apples to apples comparisons.

In addition, the increasingly watchful eye of regulatory bodies has put pressure on alternative investment firms to be more transparent regarding fees and expenses paid to them; and to provide more adequate disclosures around performance results of the funds/investments they manage. Complex transactions with complicated fee structures are now subject to scrutiny. Some state regulators now require state pension plans and other state funds to provide more disclosure about fees they pay to alternative investment managers as part of their fiduciary responsibilities to their beneficiaries and taxpayers.

As regulators' attention has turned to real estate during the past several years, it has become apparent that the private institutional real estate industry does not have a consistent and transparent approach to the presentation, calculation and disclosures of IRR, gross of fees and promote, net of fees and promote. This lack of consistency may result in flawed comparisons or incorrect conclusions. Our industry lacks consistency in its fund documentation as it relates to what can and cannot be charged to a fund, and further lacks commonality of classifications and definitions. In addition, there is a considerable degree of inconsistency in how internal rates of return are being calculated. Investors need, and now require, the ability to compare IRRs across investments and understand the underlying components of the return calculations. Although many groups are working towards improving such weaknesses currently the information disclosed in financial and other performance reports to investors fail to provide this much needed additional transparency, consistency and comparability for investors. Clearly, detailed industry guidance is necessary in order to gain wide acceptance of a unified approach to defining, calculating, measuring and presenting IRR information.

The mission of the NCREIF PREA Reporting Standards ("Reporting Standards") is to establish, manage and promote transparent and consistent reporting standards for the real estate industry to facilitate informed investment decision-making. Accordingly, the Reporting Standards Council ("Council") approved the formation of a project task force to tackle this complicated issue.

As noted in the Reporting Standards Research Paper, Gross and Net IRR, *Adding transparency and comparability to closed-end fund performance and highlighting unique considerations for Investor Specific Reporting*, the task force conducted extensive research and analysis in order to formulate its recommendations. This work included:

- Researching and documenting inconsistencies in current IRR reporting practices.
- Assessing stakeholder sentiment including any perceived voids in information; how, when and what type of information facilitates understanding and analysis.
- Reviewing the related standards promulgated by the Reporting Standards Foundational Standards and understand the roles of regulators and legislatures to ensure our guidance can serve to mitigate some of their concerns surrounding transparency and disclosures.
- Reviewing current industry initiatives and leverage key conclusions where possible.
- Developing an easy to understand hierarchy between gross IRR, net IRR, including:
  - a clear identification and definition of IRR, gross of fees and promote, net of fees and promote;
  - components included within each level; and
  - definitions of the components.
- Developing underlying calculations and disclosures and address implementation challenges.

The task force concluded that a hierarchal approach (levels), coupled with clear identification, definition and mapping of fees and costs would result in much needed additional transparency on since inception IRR, gross of fees and promote, net of fees and promote reporting and allow for cross comparability of closed-end funds for investors.

The Research Paper should be carefully considered when responding to this exposure draft.

Proposed changes to Required and Recommended Elements

A summary of the recommended fund level hierarchy and proposals for integration into NCREIF PREA Reporting Standards are presented below[1].

Fund Level Reporting Hierarchy

- Level 1: Gross IRR before investment management fees and fund Costs[2]. The level 1 IRR can be calculated using two methods[3]:
  - Level 1a – IRR reflects cash flows between a fund and its investments.
  - Level 1b – IRR reflects cash flows between investors and the fund.
- Level 2: Fund Gross IRR after deduction for fund costs but before deduction of recurring, transactional and performance-based investment management fees.

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[1] While the hierarchy was created to specifically address closed-end fund issues, we believe that many of the recommendations can be tailored for applicability to separate accounts and open-end funds at a later point in time.

[2] Level 1 should be presented net of transaction related costs (other than transaction costs deemed to be transaction fees) and deal level expenses.

[3] Optionality is provided in Level 1a and 1b to allow for a cash flow starting point of property cash flows or fund level cash flows. This was necessary due to divergence of opinions as to the appropriate starting point of level 1. The remaining levels all reflect cash flows between investors and the fund.

- Level 3: Level 2 less ongoing and transactional investment management fees[4].
- Level 4: Level 3 less performance-based investment management fees (AKA incentive fees, carried interest and "promotes").

The Reporting Standards Council proposes the following changes to the required and recommended elements surrounding IRR reporting.

Comparison of Quarterly IRR Requirements			
Required or Recommended per Vol 1	**Description**	**Proposed change**	**Proposed required or recommended in RS 2020**
Required	Since inception IRR gross of fees	Change from requirement	Recommended
Required	Since inception IRR net of fees	None	Required
Disclosures when IRR's are presented			
Required	Gross of fees: types of fees deducted from gross return to arrive at net	Move: types of fees deducted from gross return to arrive at net to "net of fees" disclosures below	N/A
		Add: type/level of gross IRR reporting	Required
		Add: Levels 1a, 1b or 2 as preferred gross of fee reporting	Recommended
	Where a subscription line is used, disclose:	Year of first investment of the fund	Required
		Length of time between the first investment and the first capital call	Required
Required	Net of fees: Presented for all investor classes. If fees billed separately and/or different fee arrangements exists, disclose impact on IRR at a minimum as a basis point range.	Add: type/level of net IRR reporting	Required
		Add: Level 4 as preferred net of fee reporting	Recommended
		Add: types of fees deducted from gross return to arrive at net	Required
		Add: When Level 1 IRR is presented, stipulate	Required

[4] Determination of whether a transaction related charge is a transaction cost (included in level 1) or a transaction fee (included in level 3) should be treated consistently with the framework provided in the RS standards and recently issued global TGER paper.

		that the spread between gross and net includes fund load/fund costs.	
Required	Time period and frequency of cash flows: time period for calculation and frequency of cash flows- quarterly minimum and beginning 1/1/20 minimum is monthly.	none	Required
	(New*) Realized IRR end date: Must disclose ending date of realized IRR calculation. If final net assets of fund/property haven't be distributed as of the IRR end date, the method used in determining the final distribution and IRR end date must be disclosed.	none	Required
*Approved by Council in connection with changes to TWR in fall of 2018.			

Investor Specific Reporting: A word of caution

These standards are applicable to fund level IRR's reported for US closed-end commingled funds. The fund net IRR (shown above as Level 4) does not take into consideration specific negotiations between investors (e.g. side-cars) or groups of investors (e.g., feeder vehicles) that participate in the fund. Additional reporting may be considered appropriate for those situations including:

- An aggregation of Limited Partner investor level reporting including all feeder specific costs other than fees
- An individual Limited Partner specific reporting which captures the experience of a single investor, including all investor specific timing, fees and costs.

Conclusion

In consort, the research, calculations, disclosures and implementation guidance, detailed within the Research Paper provide a consistent and transparent framework to address many of the issues associated with inconsistencies in Gross and Net IRR reporting. When approved, the new required and recommended practices will serve as a common language for investors, managers and other stakeholders which may be built on over time to further the goals of transparency and comparability. It should be noted that the proposed recommendations are compatible with incoming guidance from the Total Global Expense Ratio (TGER) sponsored by the Reporting Standards, INREV and ANREV as well as the GIPS 2020 standards.

Invitation to comment

The NCREIF PREA Reporting Standards Board ("Board") and Council seeks comment on the proposal set forth here regarding changes to the IRR required and recommended elements and related disclosures within the Reporting Standards.

Nine questions are included in this document to obtain feedback on specific issues. In addition to responding to these questions, please provide feedback on this document and the Research Paper referenced, including items you support. All comment letters will be considered and are greatly appreciated.

Comments must be submitted and received no later than November 8, 2019. Responses will be accepted by e-mail or hard copy only, using the form provided or a format the respondent chooses. Unless requested otherwise by the responding organization, all comments and replies may be made public on the Reporting Standards website (www.reportingstandards.info). Comments may be submitted as follows:

Email: administrator@reportingstandards.info

Post: NCREIF
Attn: Director, Reporting Standards
200 East Randolph Drive
Suite 5135
Chicago, IL 60601

Questions for consideration and response

1. Within the Reporting Standards for closed-end funds, should gross IRR remain a requirement?
   a. Yes
   b. No-make it a recommendation
   c. No-neither require nor recommend
2. If you answered that gross IRR should be required or recommended in RS, do you think that the reported IRR be at a specific level (e.g., 1a, 1b or 2) described in this paper?
   a. Yes
   b. No
   c. Please explain your answer
3. If you answered yes to question 2 above, which level of gross IRR should be the standard?
   a. 1a
   b. 1b
   c. 2
   d. Other, please describe
4. If you answered no to question 2 above, do you think that the level of gross IRR reporting should be a required disclosure?
   a. Yes
   b. No
   c. Please explain any no answer.

5. Do you agree that the requirement to report net IRR be at level 4 as described in this paper?
   a. Yes
   b. No
   c. Please explain any no answer
6. Do you agree that the disclosures required for either gross or net IRR which are listed in the table are appropriate?
   a. Yes
   b. No
   c. Please provide suggestions for changes and/or additional disclosures.
7. How do you generally present IRR's in closed-end fund marketing/offering materials?
   a. Gross and net IRR
   b. Only net
   c. Other
8. If you answered "a" to question 7, what level to you present gross IRR?
   a. 1a
   b. 1b
   c. 2
   d. Other, please explain
9. If you answered "a" or "b" to question 7, do you present net IRR at level 4?
   a. Yes
   b. No
   c. Other, please explain

Exhibit 1: Expanded Discussion of Proposed Hierarchy

Level 1

Within this hierarchy, Level 1 is the IRR of the Fund without regard to advisory fees (Ongoing, Transactional and Performance-Based) and fund costs (sometimes referred to as Fund Load). Level 1 should be net of all transaction specific costs which would be incurred during the normal investment process. Any transaction-based fees, which are not in lieu of a market transaction cost (such as a broker's fee), should not be deducted at this level (these fees will be incorporated at level 3). Additionally, level 1 should be presented net of all deal-level promote structures with joint venture partners.

During the research phase, there was substantial discussion surrounding the starting point of level 1 returns. The differences primarily landed in two camps, with the first looking first at deal-level flows (flows from the fund to individual investments) and the second focusing on investor level flows (flows from investors to the fund). As there was no clear consensus, the task force provided optionality at this level to address the concerns of both camps within the hierarchy framework. Some key differences between the two methods are presented below and detailed in Appendix B. Level 1a

- Utilizes fund to investment flows.
- Is unleveraged to the extent that fund to investment cash flows include cash derived from subscription line and fund level leverage.
- More directly comparable to individual deal IRR's (See investment level IRR guidance in the RS performance and risk manual).

- Level 1b
  - Utilizes investor to fund flows.
  - Net of all forms of leverage[5] (fund, subscription and deal-level) utilized by the fund.
  - When compared to Level 2, this method isolates the impact of "fund costs" without other noise generated from cash flow timing differences (internal fund cash management, subscription line usage, etc.).

<u>Level 2</u>

The Level 2 IRR builds further on the Level 1a IRR return and deducts fund related costs[6]. This IRR reflects investor's experience with respect to the investments in the fund without regard to how the investment manager is compensated. Level 2 considers items of fund load (without fees) and is net of both fund, subscription, and investment leverage, interest expense/income from credit facilities or cash deposits.

Level 2 should be consistent with fund or account level gross time weighted return calculations required in the Reporting Standards as they are net of transaction costs and fund costs but are before investment management fees. They would be different solely due to calculation differences such as TWR start and end dates and calculation methodology (Linked Modified Dietz vs IRR).

<u>Level 3</u>

Level 3 begins with Level 2 and deducts ongoing investment management fees and transaction fees which are not classified as transaction costs and deducted in level 1. Any fee rebates or refunds are to be included here, regardless of where they occur. If, certain fee rebates or refunds cannot be included for whatever reason (e.g. confidentiality, difficult to allocate combined fund balances rebates, etc.), it is recommended that a general footnote be included describing the reason.

<u>Level 4</u>

Level 4 begins with level 3 and deducts performance-based investment management compensation, such as incentive fees and carried interest (promotes), net of any claw backs. Any GP Interests which are pari passu to the LP interests are included in level 1-4. In this step, the carried interest entity or portion of the GP should be deducted to produce a net LP IRR. If the GP interest contains both pari passu and carried interest elements and cannot be segregated, the entire GP interest should be deducted at this level. While not common, if a substantial portion of the fund is non-fee paying, it is recommended that this fact be noted in the IRR disclosures due to the potential impact on the Net IRR.

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[5] Contemplates all forms of leverage managed through the fund structure and its feeders. As financing structures are very diverse, this is not intended to address fund leverage occurring outside the investment vehicle, such as individuals using levered lines or other sources of leverage to fund capital calls.
[6] As further discussed in the TGER framework as "vehicle-related costs".