NCREIF PREA

Reporting Standards

Guidance Paper

ENHANCING COMPARABILITY OF COMPONENT RETURNS WHEN BENCHMARKING TO NFI-ODCE

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Enhancing Comparability of Component Returns when Benchmarking to NFI-ODCE

Background

The NCREIF Open-End Diversified Core Index (NFI-ODCE) is the most widely used and recognized index for non-listed real estate fund performance. Investment managers with funds that are not included in NFI-ODCE (for various reasons such as structure and strategy) are frequently asked by investors, internal users and other stakeholders to compare their time-weighted return (TWR) performance results to NFI-ODCE. Sometimes these comparisons are on a total TWR basis and other times, component returns (i.e., income and appreciation) are compared as well.

Frequently, inputs to TWR calculations are derived from the financial statements. Historically, there have been two primary reporting models used for financial statement presentation:

- the Operating Model, which is rooted in providing a "gross presentation" on the balance sheet and income statement (i.e., showing various categories of assets and liabilities from investments on the balance sheet and multiple revenue and expense line items on the income statement reflecting the operations of the underlying investee properties). Additionally, income is recognized as earned using accrual-based accounting rules irrespective of whether cash is distributed from investee properties up to the fund which invests in them; and

- the Non-Operating Model, which has its roots in investment company accounting and provides a "net presentation" (i.e., showing investments recorded as a single "net" line item on the balance sheet and income statement). Under this model, income is recognized as dividend income only to the extent cash generated from earnings is distributed from investee properties up to the fund which invests in them, and undistributed income is recognized as unrealized gain when the fund fair values the net working capital of its underlying investment in real estate.

A third presentation model has also existed within the industry for some time. This third model combines concepts from each of the two models above, with the balance sheet presented under the Non-Operating Model but the income statement with income recognition following the Operating Model (i.e., using accrual-based accounting also known as the equity in earnings method as opposed to recognizing pure cash distributions). This third model is often referred to as Operating Model – Net. This third model leverages concepts from both models to improve overall comparability, which is discussed in greater detail below.

It is important to note that net asset value (NAV) under either the Operating or Non-Operating Model should be the same. Accordingly, the total TWR result is also the same under both reporting models. However, due to accounting rules relating to consolidation and dividend reporting, total net income and total appreciation can be materially different depending on which presentation model is selected. There is no requirement to utilize a particular reporting model and investment advisors typically make decisions on which reporting model to use based on the needs and expectations of the investors/users of the financial statements as well as the needs of the broader investment firm. Please see the Fair Value Accounting Manual for further information and details.

A recent survey confirmed that nearly all NFI-ODCE funds utilize the Operating Model and thus recognize income as it is earned using accrual-based accounting. This is important information to know if a fund's performance is being compared or benchmarked to NFI-ODCE and the fund reports on the Non-Operating Model. Income recognition between these two models is different and thus may impact the comparability of income and appreciation component TWRs.

An illustration of the differences described above is included on the next page.

Illustration of Impact of Accounting Model on Component Return

	Operating Model (Gross)	Operating Model (Net)	Non-Operating Model (Dividend Income)
Consolidated Statements of Net Assets			
Real estate investments	$ 500	$ 200	$ 200
Notes payable	300		
Net Assets	$ 200	$ 200	$ 200
Consolidated Statements of Operations			
Revenue from real estate investments	20		
Earnings from real estate investments		13	
Income distributions from real estate equity investments (div income)			8
Total Income	20	13	8
Real estate expenses and taxes	7		
Net Investment Income	$ 13	$ 13	$ 8
Net realized and unrealized gain (loss):			
Realized gain from sales of real estate invest.	6	6	11
Less: Previously recorded unrealized gain on sales of real estate invest.	(2)	(2)	(3)
Net realized and unrealized gain from the sale of real estate invest.	4	4	8
Unrealized gain (loss) on real estate investments and improvements	5	5	6
Net realized and unrealized gain	$ 9	$ 9	$ 14
Net increase in net assets resulting from operations	$ 22	$ 22	$ 22

The Net Investment Income under the Operating Models (Gross and Net) is $13.
The Net Investment Income under the Non-Operating Model is $8.

The Net Realized and Unrealized Gain under the Operating Models (Gross and Net) is $9.
The Net Realized and Unrealized Gain under the Non-Operating Model is $14.

Total Net increase in net assets resulting from operations under all models is $22.

Component Returns under each model are:

Income Return	6.5%	6.5%	4.0%
Appreciation Return	4.5%	4.5%	7.0%
Total Return	11.0%	11.0%	11.0%

As demonstrated above, a fund's income return under the Non-Operating Model is not comparable to a benchmark income return that utilizes the Operating Model (Gross and Net) such as NFI-ODCE. Therefore, some funds will convert component returns on the investor reports to align with NFI-ODCE component returns to foster comparability.

Considerations When Adjusting Returns for Comparison to NFI-ODCE

The income return hinges upon the definition of net investment income which provides a framework of considerations when adjusting component returns for comparison to NFI-ODCE.

Under the Operating Model (Gross or Net):

- Net investment income is a measure of operating results.
- It is primarily intended to provide a measure of contractual ownership share of the operating activity, exclusive of capitalized expenditures, such as leasing commissions, tenant improvement costs, tenant inducements and other replacement cost that can be capitalized if in accordance with GAAP.
- Rental income is recognized when it is contractually billable to tenants (i.e., straight-lining of rents is not applicable when real estate is reported at fair value). The recognition of rental income matches appraisal methodology which factors in the future rental income in the determination of property value. Accruing for free rent/stepped rent would in essence be accounting for the same item twice (i.e., once in the property's valuation and aging in an accounts receivable/other asset account outside the property base).
- Expenses are generally recognized when the obligation is incurred.
- Certain expenses may be based on the investment vehicle's unrealized change in net asset value, including, for example, incentive management fees, and are recognized as a component of the unrealized gain or loss.

Disclosure When Presenting Comparison to NFI-ODCE

For performance reporting purposes and to show performance comparable to methodologies used in market practice (as in the case of NFI-ODCE), with proper disclosure, it is acceptable and common practice to convert the income and appreciation return components to reflect the underlying attributes of performance. In all cases, income metrics should correspond to the books and records of the fund, its investments, underlying properties, or legal entities. Funds that present component returns comparable to the Operating Model (Gross or Net) but have financial statements presented under the Non-Operating Model should include explicit disclosures explaining the basis for which their component returns were derived.