

Valuation Committee Meeting Notes

by *Del H. Kendall, MAI*

The National Council of Real Estate Investment Fiduciaries' (NCREIF) 2009 Winter Conference took place in Salt Lake City, Utah, March 10–12. The initial session focused on updating committee members on industry issues impacting NCREIF's Valuation Committee members, as well as the valuation profession in general.

After a welcome from Committee Chair Stanton West, MAI (State Teachers Retirement System of Ohio), Marybeth Kronenwetter, the REIS (Real Estate Information Standards) administrator, reported on an exposure draft being developed by NCREIF in response to Global Investment Performance Standards (GIPS) 2010.

To provide some background, GIPS are administered by the Chartered Financial Analyst (CFA) Institute. The GIPS set performance measurement standards that are used by many non-U.S. companies and a number of U.S. companies that have global interests.

While many real estate funds and investment companies already follow GIPS standards, their adoption is expanding as the industry evolves to a more global one. Key among GIPS standards is their emphasis on mark-to-market accounting, which requires that real estate assets be carried at fair value. For many U.S. entities owning real estate, this is a change from the cost-based accounting, which often obscured the value of underlying real estate assets and failed to offer transparency to potential investors.

One of the points of discussion for GIPS 2010 was a proposed change in the frequency of required external valuations to at least once every 12 months, rather than the current requirement of once every 36 months. This standard would become effective for reporting periods beginning on or after January 1, 2012. Both the current and proposed change call for the valuation to be performed by a profession-

ally designated, certified, or licensed commercial property valuer/appraiser.

Kronenwetter informed the committee that responses to the draft GIPS are due by July 1, 2009. Ellie Kerr (JPMorgan Asset Management), of the Valuation Committee and an REIS Council member, is serving on a task force that is putting together a response to GIPS 2010. A substantial contingent of NCREIF membership supports the current 36-month standard. Many of the real estate funds included in the GIPS 2010 have internal staff that already values their properties quarterly, and they would argue they have a better understanding of the property's value than an external appraiser. Also, cost could be an issue for smaller funds, which would be required to hire external appraisers annually.

Those arguing for the 12-month option contend that with external appraisers, there will be greater transparency for investors. Also, there is the benefit of offering a high level of professional valuation skills that would complement those of internal staff. NCREIF members are encouraged to read up on GIPS and improve their understanding of this set of standards that will continue to have an increasing impact on the valuation industry.

Another topic being considered by NCREIF is the valuation of debt. John Baczewski (Real Estate Fiduciary Services, LLC) is chairing the task force. The procedures for valuing debt are dictated by the Financial Accounting Standards Board (FASB), with FAS 157 the latest statement dictating fair value standards.

Stanton West then led an open discussion entitled "What Is It Worth Now?!" The worldwide economic turmoil has had a dramatic impact on real estate valuations. There have been very little sales or leasing activity, making it extremely difficult to pinpoint market value estimates. The few sales that have occurred are distressed since they involve motivated sellers, and therefore are not accurate comparables within

the market. It was argued that in these instances, the *market value* definition's requirements for a "willing seller" and absence of "undue duress" have not been met. A contrarian argument noted that if a property being valued were put on the market by a seller that is willing and not under duress, the price still would be affected by the fact that it would be competing with distressed properties. Though alternative views abounded, the group thought that care should be taken in understanding the motivation of the seller in confirming comparable sale transactions.

A discussion of the profile of sellers in the current market identified those who have been active. Open-ended, commingled funds have experienced instances of redemption requests from investors who seek a buyout of their investment by the fund. With depressed market pricing, many funds are reluctant to sell, but those that have sold are obtaining prices substantially below the market peak of 2007. Other sellers were described as property owners with loans coming due and little hope of finding refinancing on their existing balances. Most debt was reportedly available only at a 50% or less loan-to-value ratio and a 1.5 debt coverage ratio. Discussion participants noted a third source of sellers—funds that had become overweighted in real estate and needed to sell assets to rebalance the portfolio.

The general session on the second day of the conference was headlined as "Four Forecasts." The panelists included an excellent lineup comprised of Ken Riggs, MAI (Real Estate Research Corporation), Bill Wheaton (Torto Wheaton Research), Glenn Mueller (Dividend Capital and University of Denver), and Hans Nordby (Property and Portfolio Research, Inc.). The panel was moderated by Monica Parikh (Metzler North America Corporation).

Parikh started the questioning by asking what some of the best opportunities are for investors in the current market. Nordby opined that large portfolios have been more heavily discounted than single assets, though financing was difficult to obtain for larger loan amounts. Mueller stated that community retail centers should be a target, with a focus on higher-quality tenancy that includes one of the top-two grocery stores in the market.

The theme of placing greater emphasis on tenant credit worthiness was voiced throughout the conference, as the weak market has placed many tenants at high risk. The repricing of apartment and industrial properties could make them a best buy in 2010, ac-

ording to Riggs. His firm's research has suggested that values may decline another 20% from current levels, a sobering thought for property owners.

In diagnosing the current recession, it was noted that job losses had begun affecting smaller firms. Of the 650,000 job losses in February 2009, nearly 25% were by firms of less than 50 employees, with over 50% by firms employing from 50 to 500 employees. The losses by firms employing over 500 individuals dominated layoffs in the early months of the recession, but at the time of the NCREIF meeting, these represented less than a quarter of the losses.

In viewing the geographic impact of the recession, Wheaton stated that West Coast ports had a problem due to changes in the import path of goods. This was bad news for the already struggling Inland Empire submarket (east of Los Angeles, including San Bernardino and Riverside Counties). The first cities in the country expected to recover, according to Mueller and Wheaton, include Denver and Texas cities, while the 24-hour cities of Boston, San Francisco, and Washington DC, had strong dynamics that would enable an early recovery.

Regarding a recovery timetable, Mueller felt that the gross domestic product (GDP) would turn positive in the third quarter of 2009, though employment would not begin increasing until 2010. Given weak market conditions, the panelists were asked their recommendations about which properties to sell. Mueller stated that apartments were still overpriced and represented a good selling opportunity, while Riggs suggested that regional malls should be sold. Regional malls, as a property type, experienced a 40% increase from 2001 to 2007, with only a 9.5% downward correction since that time, so they still have a long way down to go. Wheaton confirmed retail real estate's outlook is declining. He noted that Internet sales continue to take a larger share of the retail market. The possibility of higher gas prices in the future also confirms real estate's declining outlook.

The panelists were asked by Parikh what events would signal that a recovery had started. Riggs's contention that financial stabilization must first occur encompassed the thoughts of Nordby when he stated that corporate bond spreads would begin to narrow. Although the media tends to focus on employment, the speakers suggested recovery of that sector would have to be preceded by financial stabilization. Observable signals of this stabilization would be GDP growth, and consumer sales and consumption increases. Employ-

ers will only add jobs after they perceive the recovery is sustainable, Wheaton stated.

A joint session of the Valuation, Accounting, and Plan Sponsor Committees offered a presentation titled "A Case Study Look at Joint Ventures." Stanton West moderated the panel that included Josh Myerberg (Morgan Stanley) and Devon Olson, MAI (Real Estate Director of Utah Retirement Systems).

Myerberg noted that the biggest challenges in creating an effective joint venture are the alignment of interests between the parties and assigning control rights. He noted that valuing joint ventures requires determining the type of structure. Operational structures involve a sharing of functions, while financial structures revolve around a division of economic interests. When advising a party in developing a joint venture, Myerberg stated that the objective is always to maximize return and minimize risk.

Olson's employer is involved in numerous joint ventures. He indicated that joint ventures will face several threats from the current liquidity crisis. Generally, poor economic performance will strain revenues by reducing promote fees (fees received by a partial investor or management interest when revenues exceed preset benchmarks). Also, acquisition professionals will have to shift to asset management, and it will be challenging to maintain key personnel.

The final Valuation Committee session began with the presentation, "NCREIF Valuation Committee's Roles and Goals on International Valuation Standards—A Presentation and Open Discussion." The presentation was provided by Brian Glanville, MAI (Integra Realty Resources, Portland). Glanville is a member of the International Valuation Standards Council (IVSC) Professional Standards Board and the Royal Institute of Chartered Surveyors Americas Valuation Council.

The IVSC's primary goal is to promote consistency in international valuation standards through a principle-based system. With the increase in real estate investments by globally active interests, Glanville voiced the need for U.S. valuation practitioners to be active in providing input into domestic valuation initiatives. These include the U.S. Securities Exchange Commission's efforts to adopt mark-to-market international accounting standards.

Glanville requested that NCREIF consider joining IVSC in order to participate in efforts to develop consistency between U.S. and international valuation standards. The Valuation Committee passed a motion to express interest in exploring IVSC sponsorship

or membership by NCREIF. A strong argument for NCREIF's activism in the IVSC is that the absence of participation would mean that the major pension fund representative organization in the United States would be absent from discussions of international standards. A policy of isolation has not been viable politically for several hundred years, and for many of the same reasons such a policy would not be beneficial to the interests of U.S.-based valuation professionals now.

The last item of discussion included a presentation by Chuck Dannis, MAI, SRA (Crosson Dannis, Inc.), informing the Valuation Committee about a new organization, the Chartered Realty Investors Society. This organization seeks to credential commercial real estate investors through an educational process. The process includes various levels of examinations, with Level 1 targeting those with several years of commercial real estate investment experience and Level 2 targeting a higher level of experience, likely in the 6- to 8-year range.

It is apparent from these NCREIF meetings that practicing professionals need more education on current industry trends. The distressed economy requires a deeper understanding of macroeconomic conditions. Declining market fundamentals have led to lower occupancies, placing more emphasis on projecting prolonged absorption periods and the resulting impact on values. Additionally, the absence of sale comparables necessitates greater reliance on anecdotal and qualitative information.

The NCREIF meeting on June 16–19 in Chicago extends the conversations of the Winter Conference and will assist attendees in navigating through these turbulent times. Please visit www.ncreif.com for further information on this NCREIF conference.

Del H. Kendall, MAI, CRE, is the current vice chair of the NCREIF Valuation Committee. He is a managing director with Real Estate Research Corporation, and heads their Houston, Texas, office. His areas of expertise include appraisal management, valuation consulting, and litigation support. Kendall also serves the Appraisal Institute as a member of the Commercial Appraisal Report Standards committee and is its representative on the Glossary of Terms Committee of the National Association of Industrial and Office Properties.

Contact: dkendall@rec.com