



NCREIF PERFORMANCE MEASUREMENT COMMITTEE ADVISORY FEE NOVEMBER 2011

Prepared by:
The Denominator and Fee Survey Subcommittee

Subcommittee Members:

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EXECUTIVE SUMMARY

The fees survey responses from NCREIF Data Contributing Members indicate some key areas of consistent practice and other areas of divergence of practice relative to the "Fair Value" accounting policies and rate of return impact for Investment Management Fees ("Advisory Fees"). These results reinforce the need for continued emphasis on the REIS disclosure requirements relating to Advisor Fees, as well as better guidance and standards regarding the definition of fees for purposes of explaining the true difference between gross of fee and net of fee performance.

BACKGROUND

Back in 1998, the NCREIF Performance Measurement Subcommittee authored a Position Paper called "Treatment of Advisory Fees. At the time there was little guidance on which Advisory Fees are added back to the net of fee performance in order to calculate gross of fee performance. At the time of the Advisory Fee Position Paper, Carried Interest had just started to be used in the industry and was not part of the survey. It was not until 2004, that a Position Paper was published called "Accounting and reporting for Carried Interest". This was the first published article that provided NCREIF guidance on how to account for and report performance using Carried Interest.

Based on the above, The 2010 REIS Performance Measurement Resource Manual incorporated the findings and section 2.11(g) recommends that before and after fee TWR denominators are the same (position unchanged in draft 2011 PM Manual 2.12(i)). The 2010 REIS Fair Value Accounting Policy Manual section 3.10 deals with how to account for Advisory Fees. Both Manuals as they are currently written and recommended draft changes that are out for review do not discuss Carried Interest.

GOAL

The Goal of the "fees survey" is to document current practice for the reporting of Advisor Fees

- accounting policy
- rate of return impact

With emphasis on:

- acquisition fees
- carried interest & incentive fees
- "before fee" & "after fee" TWR denominator

NCREIF PERFORMANCE MEASUREMENT COMMITTEE

"FEES SURVEY"

1. Please supply your firm's Assets Under Management (AUM) and number of funds (accounts).

		Response Count
AUM (\$ in billions)	\$270 [broad definition]	29
Number of funds (accounts)	616 Funds (JV's)	29

Comments:

Firms responding to the survey represent:

\$164 (in billions)	60% of Market Value reported to NPI
3,696 Properties	57% of Property Count reported to NPI
\$28 (in billions)	37% of Net Asset Value reported to ODCE
8 Funds	44% of funds reported to ODCE

- NCREIF Data Contributing Members only were asked to respond to the survey.
- Firms were asked to report "predominant practice" if there was divergence of practice among their funds.

2. Your firm's fee structures include which of the following types of fees?

(Check all that apply for each type of fee) *Note-Carried Interest and Incentive Fees are both performance based, however Carried Interest relates to partnerships where the allocation of profits to the General Partner (Manager) is a reduction of Limited Partner (Investors) equity. General Partners don't refer to Carried Interest as a fee but rather as return of capital for tax purposes, however for performance reporting purposes Carried Interest is required to be treated as a fee.

	Carried Interest	Incentive Fees	Response Count
Open-End Commingled Funds	33% (3)	89% (8)	9
Closed-End Commingled Funds	71% (15)	38% (8)	21
Single Client Account	41% (9)	91% (20)	22
Not Applicable (if chosen for both, proceed to Question 9)	100% (2)	50% (1)	2
TOTALS	19	24	29

Comments:

- TOTALS: There were 29 responding firms. 19 have funds with Carried Interest & 24 have Incentive Fees (not intended to foot down since firms can have multiple account types).
- RESPONSE COUNT: Example- 9 firms have Open-End Funds, 3 firms with Carried Interest and 8 firms with Incentive Fees (not intended to foot across since firms can have multiple fee types).
- Majority of Open-End Funds have Incentive Fees (likely due to typical "Core" strategy).
- Majority of Closed-End Funds have Carried Interest (likely due to typical "Value Add" & "Opportunistic" strategy).
- Majority of Single Client Accounts have Incentive Fees (likely due to less co-investing).
- Only one firm has no funds with Carried Interest or Incentive Fees.
- This is NOT a representation of current trends in structuring fees across fund types.

3. What basis of accounting recognition does your firm use to record the following types of fees? (Check one answer for each type of fee)

	Carried Interest	Incentive Fees
Accrued based on fair value of real estate investments assuming hypothetical sale based on waterfall calculations.	94% (17)	88% (22)
Cash basis	6% (1)	12% (3)
TOTALS	18	25

Comments:

- No surprise here. Majority of firms are using "accrual basis" for Carried Interest and Incentive Fees.
- One firm stated "accrual is made when it is determined that the property will be put on the market."
- No details for "cash basis" responses, but we can see they span all fund types. One firm uses "cash basis" for both Carried Interest and Incentive Fees.

4. What accounting policy does your firm use in the financial statements for the following types of fees? (Check all that apply) Note- If your firm does not bifurcate between operations and unrealized gain, select only one answer for each type of fee.

	Carried Interest	Incentive Fees	Response Count
Expense as a component of net investment income if fee results from operations.	0% (0)	60% (14)	14
Reduction of unrealized gain if fee results from changes in fair value.	26% (5)	60% (14)	17
Reallocation of profits between the GP & LP in the capital (equity) section- Income.	32% (6)	0% (0)	6
Reallocation of profits between the GP & LP in the capital (equity) section- Unrealized Gain.	58% (11)	9% (2)	13
TOTALS	19	23	28

Comments:

- Does not foot down due to bifurcation.
- Does not foot across due to multiple fee types.
- Incentive Fees - from underlying data, we can see that 5 bifurcate between expense and reduction of unrealized gain, 9 record only as expense, and 9 record only to reduce unrealized gain.
- Any idea why "reallocation of profits" would be used for incentive fees?
- Carried Interest- majority use "reallocation of profits" method consistent with NCREIF Position Paper on Carried Interest ; minority reduce unrealized gains same as for Incentive Fees (scenarios triggering this accounting treatment?).
- Carried Interest- from underlying data, we can see that 3 bifurcate between LP income and LP unrealized, 3 record only to LP income, and 8 record only to LP unrealized.

5. Which component is impacted by the following types of fees when calculating the "AFTER FEE" TWR? (Check all that apply)

	Carried Interest	Incentive Fees	Response Count
Income component	21% (4)	43% (10)	11
Appreciation component	68% (13)	74% (17)	19
No impact	32% (6)	13% (3)	5
TOTALS	19	23	28

Comments:

- Does not foot down due to bifurcation.
- Does not foot across due to multiple fee types.
- Carried Interest & Incentive Fees: We are not surprised that the majority of firms impact the appreciation component, since the fee is usually not triggered until appreciation is recorded. We are surprised to see such a high percentage showing "No Impact." Possible scenarios? For tax purposes, Carried Interest is not considered a fee but rather a special allocation of profits between LP and GP.

6. How do the following types of fees affect the calculation of the "BEFORE FEE" TWR Denominator? (Check one answer for each type of fee)

	Carried Interest	Incentive Fees	Response Count
"Unpaid portion" added back to the "after fee" denominator to calculate the "before fee" denominator. (a checkmark here means that your firm uses a DIFFERENT denominator for before and after fee calculations)	11% (2)	8% (2)	2
"Unpaid portion" NOT added back to the "after fee" denominator to calculate the "before fee" denominator. (a checkmark here means that your firm uses the SAME denominator for before and after fee calculations)	89% (16)	92% (22)	25
TOTALS	18	24	27

Comments:

- Does not foot across due to multiple fee types.
- Clearly, the Industry practice is to use the SAME denominator for "before fee" TWR & for "after fee" TWR. This is consistent with the responses to Question 11. Discuss rationale for not adding back the "unpaid portion and rationale for adding back the "unpaid portion."

11. Does your firm use a "BEFORE FEE" DENOMINATOR that is the same amount as the "AFTER FEE" DENOMINATOR for TWR?

	Response Percent	Response Count
YES	93%	25
NO	7%	27

Comments:

- Majority uses the same amount for their "Before Fee" & "After Fee" TWR denominators. This means that there is no difference between those denominators related to the "unpaid portion" of Carried Interest or Incentive Fee (see Question 6); nor is there any difference for fees that are actually paid, perhaps early in the quarter. One could even infer that there is no difference made even when a fee is paid from outside the fund.

7. Does your firm have "clawback provisions" relating to the following types of fees? (check all that apply)

	Carried Interest	Incentive Fees	Response Count
Open-End Commingled Funds	2	1	3
Closed-End Commingled Funds	9	5	13
Single Client Account	5	9	10
Not Applicable (if you check "Not Applicable" for both types of fees, proceed to Question 9)	18	17	23
TOTALS	28	28	28

Comments:

- Does not foot across or down since firms have multiple account types and fee types.
- From underlying data, we see that 37% (11) of the 29 firms have Carried Interest clawbacks across the various account types.
- From underlying data, we see that 41% (12) of the 29 firms have Incentive Fee clawbacks across the various account types.
- Bottom line, a minority of firms have clawbacks relating to their Carried Interest and Incentive Fee structures across the various types of funds.

8. Does your firm use the same accounting policy & rate of return methodology for "clawback provisions" as indicated in your response to Questions 3-6?

	Yes	No	Response Count
Carried Interest	92% (12)	8% (1)	13
Incentive Fees	92% (12)	8% (1)	13
		If no, describe	1

Comments:

Majority of firms with clawbacks use the same accounting policy & rate of return methodology as used for the fee to which the clawback relates. This indicates that clawbacks are recorded on an accrual basis just like the Carried Interest or Incentive Fee to which they relate.

9. What accounting policy is used in the financial statements to record Acquisition Fees? (Check one answer for each type of fund)

	Open-End	Closed-End	Single Client	Response Count
Capitalize to real estate investment and record related unrealized loss at closing.	80% (8)	45% (9)	41% (9)	11
Capitalize to real estate investment and add to value resulting in no related unrealized loss at closing.	20% (2)	35% (7)	45% (10)	11
Fee expensed at closing.	0% (0)	20% (4)	14% (3)	5
TOTALS	10	20	22	18

Comments:

- Does not foot across due to multiple fee types.
- Clearly, acquisition fees are capitalized and either immediately or next quarter valuation recorded as an offset to unrealized gain (loss).
- We were surprised that after the change in U.S. GAAP accounting (FAS 141R) that acquisition fees are not being immediately expensed at closing. Old habits die hard!

10. For which of the following items does your firm adjust the "AFTER FEE" NUMERATOR in order to calculate the "BEFORE FEE" NUMERATOR for TWR? (Check one answer for each type of fee)

	Not Added Back (therefore Before Fee & After Fee numerators are the same).	Added Back (therefore Before Fee & After Fee numerators are different).	Response Count
Acquisition Fees	71% (15)	29% (6)	21
Asset Management Fees	11% (3)	89% (24)	27
Carried Interest	39% (7)	61% (11)	18
Incentive Fees	17% (4)	83% (19)	23
Disposition Fees	45% (9)	55% (11)	20
Financing Fees	94% (16)	6% (1)	17
Property Management Fees	100% (16)	0% (0)	16
Development Fees	100% (13)	0% (0)	13

Comments:

- We were surprised by a slight change only in responses as compared to the 1998 survey, except for the addition of carried interest treated as a fee. While GIPS requires that investment management fees ("Advisory Fees") be added back for gross of fee performance, there is subjective analysis to consider for acquisition and disposition fees. The majority of firms do not add back acquisition fees which may result in not having a pure gross of fee return.
- There is consistency in the industry for asset management fees, carried interest, incentive fees and disposition fees.
- REIS PM Manual 2.11(b) recommends that acquisition and disposition fees should be included as advisory fees unless the fee is paid in lieu of a third party fee.
- One firm states "If fees are paid to our firm as Investment Manager, Managing Member or GP, they are added back." Nicely stated!

12. For fees paid "OUTSIDE THE FUND," does your firm subtract the fees from the "AFTER FEE" TWR NUMERATOR?

	Response Percent	Response Count
YES	57%	16
NO	4%	1
Not Applicable (if chosen, proceed to Question 14)	39%	11

Comments:

- Of the 17 firms with fees paid "OUTSIDE THE FUND", 94% (16) subtract those fees from the "After Fee" TWR numerator.
- No comments received from the firm responding "No." Uncertain about how the REIS required rate of return disclosures are handled for this situation.
- Intent was for fees paid "OUTSIDE THE FUND" to represent fees "billed to investors" for payment (ie not paid out of fund distributions).

13. For fees paid "OUTSIDE THE FUND," how does your firm treat these fees when calculating the "AFTER FEE" TWR DENOMINATOR?

	Response Percent	Response Count
Treated as a contribution on the date the fee was paid.	43%	9
Treated as a contribution at the end of the quarter the fee was paid.	19%	4
Ignored	38%	8

Comments:

- 4 of the "Ignored" responses are really N/A. So that leaves 17 firms with fees paid "OUTSIDE THE FUND". 76% of those treat the outside fees as a contribution either on date paid or at end of quarter paid. 24% of those ignore the outside fees for TWR denominator purposes.
- It seems that this 76% majority is either treating the outside fees as a contribution for their "before fee" TWR denominator or they are not following the current REIS guidance of using the "same denominator" for before and after fee TWR. (see Question 11). Interpretation?
- In tandem with Question 12, the majority of firms with fees paid "OUTSIDE THE FUND" either reduce the numerator or increase the denominator or both when calculating "After Fee" TWR.

14. For fees paid "INSIDE THE FUND," does your firm's "BEFORE FEE" TWR DENOMINATOR include an implied distribution to the investor for that fee amount, which is weighted according to the actual fee payment date?

	Response Percent	Response Count
YES	14%	4
NO	72%	20
Not Applicable	14%	4

Comments:

- For "before fee" TWR denominator, majority does not include an implied distribution that would otherwise have been made relative to fees paid "INSIDE THE FUND" (discussion?)
- These results are generally consistent with Question 11 answers indicating that majority use same denominator for before & after fee TWR.
- Intent was for fees paid "INSIDE THE FUND" to represent fees paid through fund distributions.

15. For IRR calculations, does your firm use quarterly cashflow frequency (as opposed to monthly or daily cashflow frequency)?

	Response Percent	Response Count
YES	55%	16
NO	45%	13

Comments:

- Almost an even split for IRR periodicity.
- Intent was to make this question specific to periodicity relating to Carried Interest/Incentive Fee waterfall IRR's which may differ from periodicity used for IRR performance reporting. Maybe next time.

16. Does your firm calculate "BEFORE FEE" IRRs?

	Response Percent	Response Count
YES	76%	22
NO (if no, proceed to Question 18)	24%	7

Comments:

- This question was merely a pre-qualifier to decide if responders needed to address the next question, which asked about before fee IRRs.

17. When fees are paid "INSIDE THE FUND," and when computing "BEFORE FEE" IRRs, does your firm include a distribution to the investor on the day (or nearest month for monthly cashflow periodicity) that the fee was paid, representing that the fee amount would otherwise have been distributed to the investor?

	Response Percent	Response Count
YES	71%	15
NO	29%	6

Comments:

- Since Question 14 relates to the same scope ("before fee" impact of fees paid "INSIDE THE FUND"), these results indicate an inconsistency between TWR calculations and IRR calculations. 71% majority "Yes" answers for this question means that implied distributions are factored into "before fee" IRR, but are excluded from "before fee" TWR denominators based on answers to Question 14. (Discussion).

NEXT STEPS

FOR DISCUSSION PURPOSES – WHERE DO WE GO FROM HERE?

Suggest:

1. Publish survey results.
2. Update Real Estate Historical Performance Example.
3. Education- How to calculate Fund Returns.
4. Revisit the "single denominator" issues for TWR.
5. Revisit adding back acquisition fees to the numerator to calculate Returns.
6. Reduce divergent practices by creating industry standards as to the types of fees that should be considered fees representing the difference between gross of fee and net of fee. All current fee types should be addressed (capital placement fee, acquisition fee, carried interest, expense reimbursements, etc.).