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March 30 - April 1

2016

REIT  
INVESTMENT



Public Non-Listed  
REITs

Ross Prindle

March 30-April 1, 2016

# FINRA Regulatory Notice 15-02

The SEC approved amendments to NASD Rule 2340 (Customer Account Statements) to modify the requirements relating to the inclusion of per share estimated values for public non-listed real estate investment trust (REIT) securities on account statements.

The amendments becomes effective on April 11, 2016.

Salient rule changes that will affect disclosure and practice are as follows:

- FINRA proposes two methodologies under which reported values are to be presumed reliable and included on customer account statements: (1) Net Investment, and (2) Independent Valuation.
- Net Investment may be used no longer than 2 years plus 150 days after breaking escrow. Net Investment is defined as the gross operating share price less selling commissions & organizational offering expenses.
- Guidance on valuation methodology and practice is referenced in FINRA 15-02 to the Investment Program Association (IPA) guidance on the valuation of public non-listed REITs

# Valuation – Best Practices & IPA Guidelines

- Objectives of the IPA Guidelines are as follows:
  - ✓ Promote improved uniformity and consistency of valuation techniques by public non-listed REITs (“PNLRs”);
  - ✓ Establish standards with respect to the timing of implementation and reporting of estimated valuations and enhance the disclosure of valuations and of the methodology used to develop such valuations;
  - ✓ Enhance public confidence in the PNLIR industry by improving the transparency of valuations of PNLIRs;
  - ✓ Provide information useful to assist fiduciaries of tax qualified pension, stock-bonus or profit-sharing plans,
  - ✓ Assist broker/dealers and registered investment advisors who require valuation information for client account statement reporting, due diligence reviews, and for ongoing monitoring of investment performance; and

# Valuation – Best Practices & IPA Guidelines

The term “Valuation” as used herein refers to an estimated value per share reported by the PNLR distinct from the offering price of the PNLR’s security.

- Basis of Valuations- Valuation of PNLR securities be based upon the PNLR’s net asset value per share (“NAV Per Share”).
- NAV Valuation Definition
  - ✓ Net Asset Value: *The fair value of real estate, real estate-related investments and all other assets less the fair value of total liabilities.*
  - ✓ Fair value: The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

# Valuation – Best Practices & IPA Guidelines

- Independence of Valuations & Management of Process - Establishment of a Valuation Committee comprised of independent directors responsible for oversight of the valuation process.
  - ✓ Engage third party valuation firms - ensure that valuation performed is in accordance with USPAP as well as certified by MAI members of the Appraisal Institute
  - ✓ Enterprise Value and/or Portfolio Premium is NOT to be considered
  - ✓ Review and approve the proposed valuation process and methodology to be used to determine the valuation
  - ✓ Review the reasonableness of the valuation or range of values resulting from the process
  - ✓ Recommend the final proposed Valuation for approval by the board of directors.

# Valuation – Best Practices & IPA Guidelines

- As Of Valuation Date(s) and Frequency of Valuations
  - ✓ Once Valuations commence, in accordance with 15-02 the IPA recommends that Valuations be produced at least annually thereafter (15-02 also promulgates annual valuation at a minimum)
  - ✓ IPA guidelines state that valuations are to be completed by an independent third-party every 2 years or may be performed by the Company or its advisor in the intervening years, provided the PNLR engages a qualified third-party valuation expert to provide assistance in and confirmation of the valuation process and resulting valuation. (In reality, most have had independent appraisals completed as it has better optics with broker-dealer community.)

# Valuation – Best Practices & IPA Guidelines

- Reporting of Valuations & Recommended Disclosure
  - ✓ The IPA recommends that: (i) per share valuations be reported in public filings and in annual reports sent to investors; and (ii) such reporting be accompanied by disclosure text sufficient to allow broker-dealers to provide information on customer account statements consistent with the requirements of FINRA Rule 2340 and for Stakeholders to understand the nature and quality of the valuation. **The IPA also recommends that the NL REIT disclose its valuation policies and, to the extent practicable given the specificity of its investment portfolio, valuation procedures including the anticipated role of third-party valuation experts, in its prospectus or other offering materials filed with the SEC.**
  - ✓ The IPA also recommends that PNLRs either maintain a written Valuation Policy which can be provided to broker-dealer due diligence personnel and other selected Stakeholders in accordance with policies established by the PNLR

# Valuation – Best Practices & IPA Guidelines

Each PNLR is encouraged to consider the applicability of including the following items in summary disclosures relating to the valuation:

- ✓ the process by which the valuations were conducted;
- ✓ the roles of the Valuation Committee, the PNLR's management and advisor, and third-parties involved in the process;
- ✓ the identification of the third-party valuation expert(s) their qualifications;
- ✓ the process by which independent external valuation services are conducted and their relationship to internal valuations, if any;
- ✓ the frequency of valuations, the date of the valuation being reported, and the age of the data utilized for the Valuation;
- ✓ general description of the methodology used to value the PNLR's real estate and real estate-related investments;



# Valuation – Best Practices & IPA Guidelines

Each PNLR is encouraged to consider the applicability of including the following items in summary disclosures relating to the valuation:

- ✓ description of the key valuation assumptions and any specific valuation parameters utilized, including but not limited to: (i) the weighted average and range, as applicable to the valuation method(s) used, of going-in and terminal capitalization rates, discount rates, and per unit values; and (ii) the holding period utilized;
- ✓ a statement of valuation sensitivity reflecting the impact on the estimated per share valuation of a 5% change in average discount rates in the case of discounted cash flow analysis or a 5% change in going-in capitalization rates in the case of direct capitalization analysis;
- ✓ general overview of procedures used to value debt and other balance sheet assets and liabilities and;
- ✓ general overview of procedures used to determine allocations of the PNLR's gross equity value among various classes of securities holders or unitholders, the PNLR's management/advisor and other minority interest holders;

# Valuation – Best Practices & IPA Guidelines

- ✓ disclosure of the limitations inherent in any estimated valuation and any specific limitations and qualifications relating to the Valuation disclosed by the PNLR.
- ✓ disclosure that the Valuation has been performed in accordance with the Investment Program Association Practice Guideline 2013-01, Valuations of Public Non-Listed REITs.
- ✓ disclosure concerning potential conflicts of interest with respect to the engagement of third-party valuation expert

# Valuation – Best Practices & IPA Guidelines

- **Accessibility of Non-Public Valuation Information for Broker-Dealer Confidential Use In Connection with Due Diligence**
- ✓ The IPA recommends that PNLR's allow reasonable access by broker-dealer personnel or designated due diligence representatives or consultants ("Due Diligence Representatives") to review supporting materials related to the valuation and deemed relevant to evaluating the nature and quality of the valuation, subject to the following provisions:
  - the broker-dealer and its Due Diligence Representatives enter into mutually satisfactory non-disclosure agreements with the PNLR and the valuation expert;
  - the broker-dealer and/or its Due Diligence Representatives acknowledge their observance of the proscriptions on use and communication of nonpublic information as set forth in SEC Regulation FD; and
  - the broker-dealer and/or its due diligence representatives agree that PNLR representatives be given the opportunity to participate in any discussions between the broker-dealer or its due diligence representatives and the independent valuation expert(s) concerning the valuation process and results.