

Real estate research blast

Praise the appraisal

Analysts face obstacles when applying financial statistics—often used to describe public equity investments—to private institutional real estate positions. For example, in order to generate the most meaningful interpretations of standard deviation as a proxy for risk, it is prudent to ensure numerous observations. Applying this metric to private real estate data can help investors understand the nature of real estate, separate from the influences of public Real Estate Investment Trust (REIT) structures (i.e., the “price-discovery” method of valuation and the managing entity within the investment).

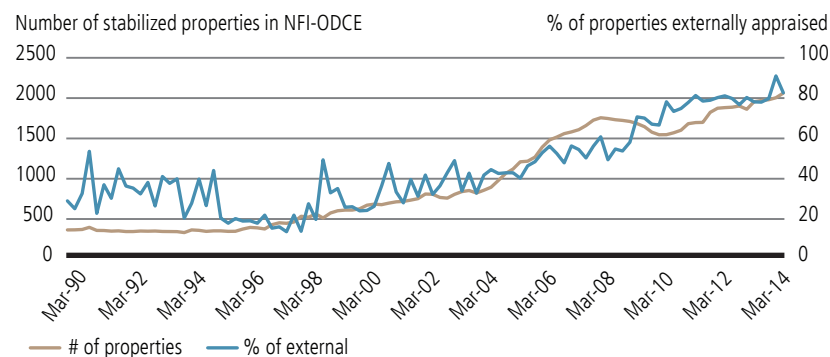
Taking one of the industry’s oldest associations, the National Council of Real Estate Investment Fiduciaries (NCREIF), as the test case, we can explore the evolution of data integrity and availability. NFI-ODCE¹ has more than quadrupled the number of core properties, from 336 properties in second quarter 1990 to 2,062 in third quarter 2014, shown in *Exhibit 1*. The deeper dataset has improved the quality of NFI-ODCE sampling data. Additionally, external valuation frequency has grown at a commendable pace, enriching the dataset.

Technological advancements allow appraisers to efficiently provide external appraisals every quarter. Managing the external appraisal process via independent organizations with growing databases of appraised properties should help lower the occurrence of outliers. However, the effect on systematic risk of valuations, with a limited number of such organizations, is still unknown.

A distinction worth noting is the definition of “external” appraisals. Typically, a third-party appraiser conducts a full appraisal review of a property annually, or sometimes more frequently if a significant event takes place (e.g., renovations, market volatility). A property is still considered to be externally appraised quarterly when only original assumptions are updated without an onsite visit.

Currently, 83% of NFI-ODCE’s core properties are externally appraised quarterly, which is in stark contrast to the 25% in the early 1990s, as shown in *Exhibit 1*.

Exhibit 1 - NCREIF’s ODCE external appraisals



Source: NCREIF as of September 30, 2014
1 NCREIF’s Open End Diversified Core Equity Index

Changes in the appraisal process *expands analysts’ toolbox.*

| NFI-ODCE characteristics | |
|-------------------------------|-------------------|
| # of funds | 22 |
| NAV | USD 121.4 billion |
| Leverage | 22.50% |
| Since inception return (1Q78) | |
| Total Gross | 8.55% |
| Total Net | 7.48% |
| Property type breakdown | |
| Apartment | 25.2% |
| Industrial | 14.2% |
| Hotel | 1.8% |
| Office | 36.9% |
| Retail | 19.1% |
| Other | 2.8% |



Real Estate Research & Strategy - US

William Hughes
Dan Bu, Kurt Edwards,
Tiffany Gherlone, Amy Holmes,
Kim House, Brian O'Connell,
Joshua Rome, Shane Russo &
Laurie Tillinghast

For more information please contact:

UBS Realty Investors LLC

10 State House Square
Hartford, CT 06103
Tel. +1-860-616 9000

www.ubs.com/realestate

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