IPD® Global Data Standards

MSCI Research

August 2015

Summary: January-February 2015 Consultation

Real estate is becoming an increasingly global asset class with new markets maturing rapidly and cross-border investment increasing. However, real estate remains extremely diverse, with many standards and conventions in existence across markets. In order to promote global consistency and comparability, we at MSCI are now reviewing and standardizing our methodologies globally. As part of this project, several methodological changes were proposed and made available for comment through worldwide public consultations in March 2014, October 2014, January 2015, and May 2015. The purpose of this note is to summarize the feedback from the January 2015 consultation, and explain how we plan to incorporate it in the proposals[1].

We greatly appreciate the consideration that has been given to the proposals and the range of comments that have been received. In the course of this note, we make reference to specific elements of feedback, summarizing these where appropriate. In order to encourage frank and open feedback, we have anonymized the individual contributions.

The proposed changes covered by the January 2015 consultation focused on the following seven areas:

1. Standard Net Income Formula and Data Collection
2. Change to Variable Currency Conversion for Capital Expenditure
3. Standardization of Gross Capital Value Derivation
4. Monthly Asset Operational Classification
5. Asset Exclusion Rules for Indexes
6. Asset to Fund Performance Reconciliation
7. Assets and Liabilities Classification

The subsequent pages provide a summary of the feedback and MSCI's planned course of action in each of the above areas.

We welcome further feedback on the specific proposals and plans. Please contact your client consultant if you wish to provide additional comments or discuss these issues further.

[1] Copies of the consultation documents and feedback notes can be found on MSCI's IPD Reporting Portal at https://padlock.ipd.com (registration required).

1. Standard Net Income Formula and Data Collection

a. Feedback overview

Overall feedback on the proposal to standardize the calculation of net operating income has been positive, with clients welcoming the potential for increased consistency across national markets. MSCI will adopt this change as its global standard.

b. Specific feedback

Comment 1: Impact of incentives

"Does MSCI's definition of rent as received include incentives?"

MSCI response: MSCI's definition of "rent as invoiced" partially reflects incentives, since rent-free periods are taken into account. However, tenant inducements in the form of capital items are not reflected within rent definitions as they are accounted for in capital expenditure.

Comment 2: Preference for accrual based net operating income (NOI) calculation

"We think that the calculation of net operating income should be based on accrued figures rather than on revenue as invoiced."

MSCI response: Our definition of "rent as invoiced" is consistent with accrual principles, as it uses the rent that is due, rather than that actually paid, excluding arrears, pre-payments, and repayments.

Comment 3: All-in rents

"In some countries, like Switzerland, the practice is for all-in rents, including operating expenditures, to be recorded. Can this distort performance measurement?"

MSCI response: This should not have any impact on the measurement of bottom-line performance, but does affect the global comparability of performance constituents (revenues and costs). MSCI's proposal to treat recoveries as a cost component should avoid any confusion in the performance calculation. In countries where all-in rents are market practice, we will work with contributors to help them estimate the proportion of rent that corresponds to recoveries in a consistent manner.

Comment 4: Treatment of key money

"With key money, there is some ambiguity in the proposal. Should income received on the key money deposit contribute to the calculation of net operating income or should only the key money itself contribute? On one hand, it can be argued that returns on key money deposits are not the product of real estate investment; but on the other, they may be given *in lieu* of higher rental payments. If MSCI is proposing to treat the key money itself as income, then how will the return of the deposit be treated?"

MSCI response: "Key money" corresponds here to payments occasionally made by potential tenants to secure a new lease. It excludes deposits paid by tenants and held by landlords against potential damages. Key money being a revenue from real estate, it should be included in net operating income calculation at asset level. By contrast, revenue resulting from the investment of deposits should be recorded at fund level.

Comment 5: Impact on the UK

"How does the assumption on recoveries (i.e. that recoveries should be treated as a cost component, not as revenue) differ from UK practice?"

MSCI response: This change will not affect the components of net income recorded for the UK, as recoveries were not previously collected as a revenue component. Recoveries were already implicit in operating expenditures since only irrecoverable costs were collected, i.e. costs net of any recovery.

2. Change to Variable Currency Conversion for Capital Expenditure

a. Feedback overview

Most respondents were happy with MSCI's proposal. MSCI will adopt this change as its global standard. However, it was noted that the formula in the original MSCI consultation document contained several typographic errors. The formula has been corrected as below.

Previous formula:

$$TR_{t\_Cov} = \frac{(CV_t * Xrate_t) - (CV_{t-1} * Xrate_{t-1}) - (CExp_t * Xrate_t) + (CRec_t * Xrate_t) + (NI_t * Xrate_t)}{(CV_{t-1} * Xrate_{t-1}) + (CExp_t * Xrate_t)}$$

New formula:

$$TR_{t\_Cov} = \frac{(CV_t * Xrate_t) - (CV_{t-1} * Xrate_{t-1}) - (CExp_t * Xrate_{t-1}) + (CRec_t * Xrate_t) + (NI_t * Xrate_t)}{(CV_{t-1} * Xrate_{t-1}) + (CExp_t * Xrate_{t-1})}$$

b. Specific feedback

Comment 1: Timing of capital expenditure

"Could MSCI not assume a middle of period timing for capital expenditure?"

MSCI response: In the absence of day dating, a practical solution would be to assume that CAPEX occurs either at the beginning, in the middle, or at the end of the month. None of these options would however solve all potential problems. MSCI has decided to assume that capital expenditure occurs at the start of the month, since the mid-month assumption creates performance spikes that are not counter-balanced by subsequent time-weighting when a property is bought or sold, and since the end-month assumption systematically favours properties with higher capital expenditures.

Comment 2: Impact of this change

"It would seem that this only affects cross-border investments and benchmarks calculated in terms of a single currency. There would be no impact for a purely domestic fund. Could you please confirm this?"

MSCI response: MSCI can confirm that this change will not affect purely domestic funds when calculating returns in their local currency. For cross-border investments exposed to currency fluctuations however, monthly movements in exchange rates will have some impact, though this is likely to be very small. The motivation for making this change is principally to achieve consistency in the timing of CAPEX.

3. Standardization of Gross Capital Value Derivation

a. Feedback overview

No participants expressed serious concerns regarding MSCI's proposal to derive gross capital value using market assumptions where estimated acquisition costs have not been provided. MSCI will adopt this change as its global standard. There were, however, a number of general questions and comments which are summarized below.

b. Specific feedback

Comment 1: Acquisition costs and shared deals

"In Belgium, transfer tax is very high, so 99% of deals are done on a shared deal basis. In situations like this, what are the appropriate acquisition costs that should be applied?"

MSCI response: Several respondents have pointed out that transaction costs can vary considerably within markets, depending on the property and the nature of the parties concerned. MSCI will consult with local appraisers and may consider making a distinction between, for example, cases of direct ownership and shared ownership through a Special Purpose Vehicle (SPV).

Comment 2: Motivation for estimating gross capital value

"Why is MSCI looking to collect information on both net capital value and gross capital value?"

MSCI response: This is to allow us to calculate comparable yield measures in all of the markets we cover. The change will make it possible to produce any of the four different yield measures currently in use by MSCI globally, applying either net or gross values in the denominator. Practices differ around the world, with some markets preferring one measure over the others.

Comment 3: Impact of this change

"If acquisition costs are provided by the client, will these be replaced with MSCI estimated acquisition costs? Also, will these acquisition costs be estimated historically?"

MSCI response: MSCI will only estimate acquisition costs when not provided by clients, and there will be no changes to historical acquisition cost data.

Comment 4: Agent fees/sellers' costs inclusion in acquisition costs

"Will MSCI include agent fees or sellers' costs in the calculation of gross capital value?"

MSCI response: Gross capital value represents an estimate of the total cost of acquiring a property, assuming that it is exchanged at its market value. Consequently, it includes all costs that would be incurred by a purchaser, including transfer tax at the rate pertaining in the location on the date of the valuation, together with notional legal and agents' fees. Sellers' costs are excluded.

4. Monthly Asset Operational Classification

a. Feedback overview

The monthly asset operational classification proved to be the most controversial proposal in the consultation. Most respondents were happy with the proposal for a more granular classification, but there was concern about MSCI's ability to accurately differentiate between stabilized and leasing investments, and to enable clients to distinguish between developments in their pre-construction and construction phases. MSCI will take on board these comments and account for them when refining the classification in future.

b. Specific feedback

Comment 1: Justification for distinguishing between stabilized and leasing investments

"We don't see enough distinction between 'stabilized' and 'leasing' assets to justify splitting them up. In our view, these assets still compete against one another and do not form distinct or easily identifiable sub-markets. As an asset owner, we would ultimately expect any assets we acquire to perform in line with our portfolio objectives, irrespective of whether they were acquired as 'stabilized' or 'leasing' assets."

MSCI response: The concept of "standing investment", including both stabilized and non-stabilized properties, will remain. The distinction between stabilized and non-stabilized assets will complement the current division between standing and all benchmarked assets. It will enable investors with core strategies to benchmark their performance against comparable assets with limited leasing risk.

Comment 2: Setting a fixed vacancy threshold

"We don't agree that a fixed vacancy threshold should be applied across markets. Structural vacancy rates vary substantially across markets, across sectors, and through business cycles. Any vacancy rate threshold should therefore be relative and vary by country and by sector."

MSCI response: The decision to adopt a fixed threshold stemmed from the need to find a straightforward but globally consistent solution. Going-forward, MSCI may consider developing relative thresholds, based on structural vacancy rates.

Comment 3: Difficulty distinguishing developments

"On the development front, whilst it makes sense to distinguish between pre-construction and construction phases, MSCI already struggles to ensure a consistent coding and assessment of developments. How will you be able to ensure that consistent definitions are applied to pre-construction and construction assets?"

MSCI response: In order to ensure consistency, MSCI will provide unambiguous and globally consistent definitions. In addition, we will continue to work with contributors who have problems in interpreting data definitions. MSCI's definitions for classifying assets under development are listed below. Pre-construction assets are classified using codes 10 to 50.

10 - Accepting Vacancies with intention to redevelop	Asset being vacated in preparation for redevelopment. A property is treated as a development if anticipated expenditure over the course of the project will be more than 25% of the start value. If it is less than 25% it is treated as a refurbishment.
20 - Empty Land or Building	Unoccupied assets or empty land prior to the start of development activity
30 - Planning permission granted	Planning permission granted for development
40 - Under Demolition	Demolition of previous building
50 - Cleared Site	Empty Site before construction
60 - Under Construction	Construction of new development
70 - Leasing	Completed asset that is being actively leased, either following development or redevelopment or as part of repositioning activity. Exclude leasing of vacancies in Stabilized properties.
80 - Stabilized	Completed properties > 6 months after practical completion certificate or more than 75% let.

Comment 4: Stabilized and pre-construction

"Will pre-construction be categorized as stabilized or non-stabilized?"

MSCI response: Pre-construction properties always fall under the status of development, whereas stabilized and non-stabilized properties always fall under the status of standing investments. Pre-construction/construction and stabilized/non-stabilized categories are therefore mutually exclusive.

5. Asset Exclusion Rules for Indexes

a. Feedback overview

In this part of the consultation, respondents generally agreed that it would be worth reducing subjectivity in the asset exclusion process. MSCI will proceed with the implementation of the methodology.

However, there was some concern regarding the continuation of exclusion rules specific to the UK and Ireland. This is to a temporary situation caused by transitional constraints, in the context of the overall aim of defining a global standard across all markets. It is not intended to treat the UK as an exception, with the objective being rather to integrate the market in the global exclusion rules.

b. Specific feedback

Comment 1: Automatic exclusion rules for the UK and Ireland

"Could you please elaborate on page 13 of the consultation document where it states that certain automatic exclusion rules will continue to be applied to the UK and Ireland? For example, which assets are excluded under the headings 'short lease' and 'long lease'?"

MSCI response: The definitions of short and long leaseholds are as follows:

- Short leaseholds: Leasehold assets with less than 30 years to lease expiry.
- Long leasehold/fixed rent properties: Assets with a current rental value more than five times greater than the expected income in 10 years time.

Comment 2: Potential inconsistency

"Why does MSCI apply specific rules for the UK and Ireland? This looks like a source of inconsistency which could affect the comparability of UK and Ireland indexes."

MSCI response: MSCI recognizes that it is not ideal to have separate rules for the UK and Ireland, but we view this as a temporary solution. Rules for the UK and Ireland should eventually converge with the global standard.

6. Asset to Fund Performance Reconciliation

a. Feedback overview

Clients expressed considerable interest in reconciliation analysis, with many agreeing that it would be a useful tool for communication with investors. MSCI will adopt this change as its global standard.

b. Specific feedback

Comment 1: Breakdown of fees

"Would it be possible to differentiate between base fees and performance fees?"

MSCI response: MSCI will consider the possibility of a further breakdown into base and performance fees. MSCI will collect total fund management fees as well as splitting them between advisory (base) and performance fees. At present, reporting is expected to be at the level of total fund management fees.

Comment 2: Distinction between fund and asset debt

"It can be hard to differentiate fund and asset debt in some circumstances. For example, how would debt secured against a portion of the portfolio be treated?"

MSCI response: We will address this by providing unambiguous definitions wherever possible. In broad terms, if the debt is secured by a specific/fixed asset (or group of assets), it should be considered as asset level debt. In contrast, floating charges (i.e. unsecured debt or debt secured by a changing group of assets) are considered as fund level debt.

Comment 3: Current MSCI practice

"How does the proposed approach relate to the methodology currently employed for the Canadian PFI?"

MSCI response: The current ordering used in the Canadian and UK markets differs slightly from the proposed methodology, in the following ways:

- The proposed methodology layers the impact of cash after that of debt, whereas the current method puts cash just before debt.
- The proposed methodology allows for the distinction between asset level debt and fund-level debt. Asset level debt will be layered just after direct assets, while fund-level debt will come after indirect assets. Currently all debt is layered after indirect assets and cash.

Proposed IGDS methodology	Current methodology (Canada and UK)
Fund level tax	
Fund level costs	
Other assets & liabilities	
Cash	Fund level costs, fees and tax
Fund level debt	Debt
Indirect Real Estate	Cash
Asset level debt	Indirect Real Estate
Direct assets	Direct assets

Comment 4: Arithmetic versus geometric differences

"In principle we agree with the proposed approach. Internally we use an arithmetic approach as it is easier to understand though probably not as accurate as a geometric approach."

MSCI response: MSCI has considered the pros and cons of the arithmetic and geometric approaches. Ultimately, the arithmetic approach was favoured for its relative simplicity and ease of communication. It has the advantage of adding up perfectly: the impact of each component can be added successively to match the fund level return. This cannot be achieved with a geometric approach which is therefore much less intuitive.

7. Assets and Liabilities Classification

a. Feedback overview

Feedback on the assets and liabilities classification was generally positive. Specific feedback is summarized below.

b. Specific feedback

Comment 1: Separation of currency and interest rate hedges

"We would like to see currency and interest rate hedges reported separately."

MSCI response: MSCI proposes to collect currency hedging and interest rate hedging amounts separately. However, the proposal is to report on the two combined, due to their small expected impact on performance.

Comment 2: Reporting of unhedged position

"In the case of interest rate swaps, we think there would be value in having funds report their unhedged exposure and the net swap payments separately. Is this something which could be built into the MSCI classification?"

MSCI response: MSCI will consider collecting and reporting this information separately.

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Our line of products and services includes indexes, analytical models, data, real estate benchmarks and ESG research.

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