Institute for Portfolio Alternatives

Modified Funds from Operations (MFFO) for Publicly Registered, Non-Listed REITs

Industry Guideline

Modified Funds from Operations (MFFO) for Publicly Registered, Non-Listed REITs

EFFECTIVE DATE

The provisions of this Practice Guideline become effective on November 2, 2010.

AFFECTED REITS

This Practice Guideline is applicable to all publicly registered, non-listed REITs (“NL REITs”).

INTRODUCTION & OVERVIEW

The REIT Committee (the “IPA REIT Committee”) of the Institute for Portfolio Alternatives (“IPA”) believes that uniformity, consistency and transparency in financial reporting among member companies is an essential component in the evolution and growth of the NL REIT industry and in providing information to securities analysts, broker-dealer due diligence officers, investment advisors, fiduciaries and investors (“Stakeholders”).Further, the IPA REIT Committee believes that the provision of certain supplemental performance measures in financial reports made available to Stakeholders will enhance the value of reporting pursuant to generally accepted accounting principles (“GAAP”), address certain unique features of NL REITs, and facilitate financial analysis of investment performance.

This Practice Guideline is the result of deliberations by the Financial Standards Subcommittee of the IPA REIT Committee (the “Subcommittee”) which commenced in late 2006 and consideration of the recommendations of the Subcommittee by the full IPA REIT Committee, whose membership sponsors NL REITs and accounts for in excess of 95% of all investment funds raised by NL REITs since the year 2000. The recommendation of the full IPA REIT Committee was subsequently reviewed by the IPA’s Legal and Regulatory Committee, the IPA’s Broker-Dealer Advocacy Committee, and the IPA’s Due Diligence Committee and received final approval of the IPA’s Board of Directors on November 2, 2010.

This release is intended to provide guidance for NL REIT managements, advisors, and boards of directors and is not intended to be mandatory. Application of this Practice Guideline for a specific company will be dependent on the structure of the company, the nature and stage of the assets held, the NL REIT’s investment objectives and investment phase, and other attributes unique to the NL REIT. Therefore, the implementation of this Practice Guideline is left to the business judgment of the management, advisor and board of directors of each NL REIT. Nothing in this Practice Guideline is intended or shall be construed to impose any legal or regulatory obligation to follow this guideline or any liability under any securities laws or regulations or otherwise for failure to do so. NL REIT managements, advisors and boards of directors should consult their individual legal and accounting professionals concerning specific implementation of this Practice Guideline and conformity of such implementation with securities and other laws and regulations.

This IPA Practice Guideline is not intended to, and does not, constitute legal or tax advice to any person or organization, nor does the IPA represent that this Practice Guideline has been approved by the Securities and Exchange Commission (the "SEC"), the Financial Industry Regulatory Association ("FINRA"), the Internal Revenue Service, the Department of Labor, the North American Securities Administrators Association ("NASAA"), or any governmental or self-regulatory organization for the purpose of fulfilling regulatory reporting guidelines. The managements of NL REITs and their Stakeholders should consult their own legal and tax advisors in connection with the use of this IPA Practice Guideline.

Background

The NL REIT industry has grown rapidly in recent years. The number of registered offerings in the market has increased from approximately five in the year 2000 to 58 in the third quarter of 2010. The amount of securities registered in these programs totaled over $94 billion as of September 30, 2010. The number of sponsors offering NL REIT securities has increased over nine-fold since the year 2000 as new sponsor companies have entered the industry, many of which are first-time sponsors of NL REITs. This proliferation of sponsors, new industry participants and programs presents an increasing challenge for the industry in terms of maintaining uniformity and consistency of financial reporting.

Due to the fact that NL REITs do not trade on securities exchanges, they are typically not followed by listed company securities analysts. Listed REITs generally disclose certain supplemental performance measures to facilitate understanding of the individual company's operating results and comparisons with other publicly traded companies. Such disclosures by NL REITs may be more problematic in light of the extended offering periods typical of these best efforts stock offerings. Such supplemental performance measures have played a role in the ability of the financial community to analyze and compare investment performance, in the growth of public confidence in the quality and consistency of reported results, and in the fostering of capital flows to the listed REIT industry.

One such supplemental performance measure, Funds from Operations ("FFO"), was developed by the listed REIT industry in 1991, and subsequently updated in 1995, 1999 and 2002. Through the efforts of the National Association of Real Estate Investment Trusts ("NAREIT"), a clear definition of FFO and its derivation was promulgated "to promote a supplementary industry-wide standard measure of REIT operating performance that would not have certain drawbacks associated with net income under generally accepted accounting principles." FFO became widely used among analysts and the investment community to aid in the assessment of listed REIT performance and fostered uniformity and comparability. However, industry observers have increasingly acknowledged certain shortcomings in FFO due in part to changes in accounting rules recognized under generally accepted accounting principles ("GAAP") and to the continuing evolution of REIT activities. Although the measure continues to be widely used, it is more frequently supplemented with additional disclosures to clarify performance. In particular, the changes in GAAP accounting rules have resulted in a substantial increase in the number of non-operating and non-cash items included in the calculation of FFO. In addition, REIT managements typically view unrealized income or losses from mark-to-market adjustments, and impairment charges and gains and losses from dispositions of assets as non- recurring items which are typically adjusted for when assessing current operating performance. FFO as a measure of performance is more appropriate for listed REITs that generally have relatively stable portfolios of investments. In contrast, NL REITs are substantially more dynamic during their initial years of investment and operation and therefore require adaptations to FFO which are not necessarily important for listed REITs.

In February of 2009, the Financial Industry Regulatory Authority ("FINRA") issued Notice to Members 09-09. Among other things, this notice advised member firms of their responsibility with respect to ongoing due diligence of NL REITs. The issuance of this notice resulted in a recognition of the need for the NL REIT industry to develop a standardized industry- wide supplemental performance measure which overcomes the existing limitations of GAAP Net Income and NAREIT FFO and which will allow broker-dealers, due diligence and securities analysts, financial advisors, fiduciaries and investors to better assess performance when used in combination with GAAP presentations required by the SEC. The IPA believes that the development of such a standardized measure to supplement GAAP net income is consistent with the SEC's Accounting Series Release (ASR) No. 142 and with its January 15, 2010 Compliance and Disclosure Interpretations, which acknowledge the potential value of disclosure of "industry standard" supplemental accounting terms.

The NL REIT industry recognizes that improved uniformity in reporting of operating performance enhances the market's ability to develop performance measures which accurately reflect results of operations. While many NL REITs now report FFO utilizing the NAREIT definition, the perceived limitations of FFO combined with the attributes of NL REITs create certain unique financial and performance reporting challenges. The startup and acquisition nature of NL REITs (where generally they begin as blind pools and undertake relatively long lived best efforts offerings) and the potential for partial portfolio liquidations and returns of capital and special distributions to investors during the operating phase, provide additional challenges not typically encountered in the traded REIT marketplace in terms of measuring performance.

OBJECTIVES OF THIS PRACTICE GUIDELINE

This Practice Guideline is designed to accomplish the following goals:

- Promote mechanisms for the assessment of operating performance reflecting both the stage of investment and the underlying financial results of the NL REIT;
- Provide a defined supplemental performance measure which, when used in addition to net income and liquidity measures such as cash flows from operating activities as defined by GAAP, will enhance the understanding of the operating performance of each NL REIT, and which is consistent with how NL REIT managements judge their operating performance and determine operating, financing and dividend policies;
- Promote uniformity and consistency of the derivation and disclosure of this supplemental performance measure by NL REITs;
- Provide information to assist broker-dealers in their ongoing due diligence monitoring of the operating performance of NL REITs consistent with the responsibilities set forth in FINRA Notice To Members 09-09; and
- Enhance public confidence in the NL REIT industry through improved transparency of the operating performance of NL REITs.

PRACTICE GUIDELINE CONTENTS

This Practice Guideline recommends adoption by NL REITs of a supplemental performance measure to be known as Modified Funds From Operations ("MFFO") and the disclosure of FFO and MFFO in quarterly and annual filings with the SEC and/or in supplemental performance reports furnished to the SEC.

Guideline: The IPA recommends that NL REITs include in their annual reports on Form 10-K and quarterly reports on Form 10-Q filed with the SEC and/or furnish in publicly disclosed Supplemental Performance Reports the following Performance Measures:

A. Funds from Operations using the National Association of Real Estate Investment Trust ("NAREIT") definition and protocols.

B. Modified Funds from Operations ("MFFO"), as defined below to be used in conjunction with net income and cash flows from operations computed in accordance with generally accepted accounting principles in order to provide an enhanced understanding of the operating performance of NL REITs.

In addition, such disclosure should include a reconciliation of FFO to net income reported according to GAAP consistent with SEC requirements, and a reconciliation of MFFO to FFO and/or GAAP net income.

Discussion: The inclusion in financial reports or supplementary performance materials of FFO and MFFO is intended to benefit NL REITs and their Stakeholders in a variety of ways, including: (1) enhancing the ability of the financial community to analyze and compare operating performance of a particular NL REIT over time and the developing stages of its operations, and among NL REITs; (2) enhancing the transparency and public confidence in the quality and consistency of reported results; (3) providing standardized information for the evaluation by Stakeholders of the operating performance of individual NL REITs consistent with how NL REIT managements, advisors and boards of directors judge their operating performance and determine operating, financing and dividend policies.

A. Funds from Operations

Guideline: The IPA recommends that NL REITs report FFO using the National Association of Real Estate Investment Trust ("NAREIT") definition and protocols for determining FFO as a supplemental measure in quarterly reports on Forms 10-Q and annual reports on Form 10-K filed with the SEC and/or in Supplemental Performance Reports which are publicly disclosed or otherwise furnished in SEC filings. Such disclosure should be done in compliance with relevant SEC rules and practices.

Discussion: FFO is a non-GAAP performance measure applicable to REITs which has become widely used and adopted as a standard among listed REITs. Pursuant to the revised definition of FFO adopted by the Board of Governors of NAREIT, FFO is calculated by adjusting net income (loss) (computed in accordance with GAAP, including non-recurring items) for gains (or losses) from sales of properties, real estate related depreciation and amortization, and after adjustment for similar items in unconsolidated partnerships, joint ventures and preferred distributions.

The use of FFO, combined with appropriate GAAP presentations, has been deemed fundamentally beneficial in improving the understanding of operating results of REITs among the investing public and making comparisons of REIT operating results more meaningful. REIT managements also generally consider FFO to be a useful measure for reviewing comparative operating and financial performance because, by excluding gains and losses related to sales of previously depreciated operating real estate assets and excluding real estate asset depreciation and amortization (which can vary among owners of identical assets in similar condition based on historical cost accounting and useful life estimates), FFO can facilitate more meaningful comparisons of operating performance between periods or as compared to other REITs.

B. Modified Funds from Operations

This Practice Guideline also suggests each NL REIT derive and report an additional supplemental performance measure, Modified Funds from Operations ("MFFO"), in quarterly reports on Forms 10-Q and annual reports on Form 10-K filed with the SEC and/or in Supplemental Performance Reports furnished to the SEC, including any additional clarifying information deemed necessary to assist Stakeholders in understanding and evaluating the operations of the NL REIT.

Definition of Modified Funds from Operations: Modified Funds from Operations shall be derived from net income computed in accordance with GAAP as follows: (a) GAAP net income, excluding any gain (losses) from sales of property, plus real estate-related depreciation and amortization, and after similar adjustments for unconsolidated partnerships and joint ventures, with such adjustments calculated to reflect FFO on the same basis, the foregoing calculations made in accordance with NAREIT protocols for the determination of NAREIT FFO; and (b) such result further adjusted for the following items included in the determination of GAAP net income: acquisition fees and expenses; amounts relating to straight line rents and amortization of above or below intangible lease assets and liabilities; accretion of discounts and amortization of premiums on debt investments; non-recurring impairments of real estate-related investments; mark-to market adjustments included in net income; non-recurring gains or losses included in net income from the extinguishment or sale of debt, hedges, foreign exchange, derivatives or securities holdings where trading of such holdings is not a fundamental attribute of the business plan, unrealized gains or losses resulting from consolidation from, or deconsolidation to, equity accounting, and after adjustments for consolidated and unconsolidated partnerships and joint ventures, with such adjustments calculated to reflect MFFO on the same basis.

For purposes of clarity, the following lists the adjustments to be included in part (b) of the above definition:

(i) elimination (add back) of acquisition fees and expenses which have been deducted as expenses in the determination of GAAP net income;
(ii) elimination of non-cash amounts related to straight line rent and the reversal of amortization of above or below market and in-place intangible lease assets and liabilities;
(iii) elimination of accretion of discounts and amortization of premiums on debt investments;
(iv) elimination of impairments of real-estate related investments (including properties, loans receivable, and equity and debt investments);
(v) elimination of realized gains (losses) from the early extinguishment of debt;
(vi) elimination of realized gains (losses) on the extinguishment or sales of hedges, foreign exchange, securities and other derivatives holdings except where the trading of such instruments is a fundamental attribute of the business plan of the NL REIT;

(vii) elimination of unrealized gains (losses) from mark-to-market adjustments on (a) interest rate swaps and other derivatives not deemed hedges under GAAP; (b) foreign exchange holdings; and (c) other securities;
(viii) elimination of unrealized gains (losses) resulting from consolidation from, or deconsolidation to, equity accounting;
(ix) elimination of adjustments relating to contingent purchase price obligations where such adjustments have been included in the derivation of GAAP net income; and
(x) adjustments for consolidated and unconsolidated partnerships and joint ventures calculated to reflect MFFO on the same basis as above.

Additional Information Deemed Appropriate By NL REIT Managements for the Assessment of Operating Performance: The IPA recognizes that creating a definitive list of all items which NL REIT managements may deem appropriate for the purpose of assessing operating performance and operational, financing and dividend policy is impractical. However, this Practice Guideline recommends that MFFO be determined and disclosed based solely on the above definition and that further information deemed appropriate and useful by management for assessing operating performance and policies not be included in the calculation of MFFO but rather be separately disclosed, accompanied by a statement of management's view of the applicability of such information for the assessment of operating performance. Any such information should be consistent with the intent of the IPA in promulgating this Practice Guideline – to provide a supplemental performance measure which facilitates the evaluation of operating performance of a recurring nature. In this regard, it should be noted when calculating MFFO that in 1999 NAREIT clarified the definition of FFO to allow for the elimination from FFO of non-recurring events defined as "extraordinary items" under GAAP.

The IPA recommends that MFFO disclosure be accompanied by a tabular derivation of MFFO from either GAAP net income available to common shareholders, and/or from NAREIT FFO. If shown as derived from NAREIT FFO, NL REITs are encouraged to provide MFFO information proximate to, or as a continuation of, the presentation of FFO. The IPA encourages the managements of NL REITs to provide additional clarifying and explanatory information accompanying the MFFO disclosure where deemed useful for enhancing the understanding of the information and to provide such disclosures as may be required by the SEC. The purpose of such information may include clarifying the limitations of MFFO as a performance measure specific to the accounting standards applied to the individual NL REIT's financial statements which may make direct comparison with other NL REITs or with prior accounting periods invalid, and to facilitate the evaluation of the individual NL REIT's operating performance.

In particular, the IPA recommends that MFFO measures be accompanied by disclosures which indicate: (i) the MFFO shown has been determined in accordance with the IPA definition of MFFO and may not be comparable to MFFO reported by other NL REITs or traded REITs that do not define the term in accordance with the current IPA definition or that interpret the current IPA definition differently; (ii) MFFO should not be considered as an alternative to net income (determined in accordance with GAAP) as an indication of the NL REIT's performance; (iii) MFFO does not represent cash generated from operating activities determined in accordance with GAAP and is not a measure of liquidity; and (iv) MFFO should be considered in conjunction with reported net income and cash flows from operations computed in accordance with GAAP, as presented in the NL REIT's consolidated financial statements.

Timing of Implementation

Disclosure of FFO and MFFO should commence for existing, operational NL REITs no later than with the filing of the annual report for 2010 with the SEC on Form 10-K, and for newly formed NL REITs at the end of the first full quarter after initial breaking of escrow. All such disclosures should be consistent with SEC Guidance and Rulings Regarding Disclosure and Use of Supplemental Performance Measures in Public Documents.