

## ***Green Street's NAV-based Pricing Model***

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**Overview:** Our NAV-based pricing model has served as our primary tool for valuing REITs since 1989. The model separately evaluates the two key determinants of value for a REIT: the net value of its real estate portfolio and the ability of management to add to (or detract from) that value.

**Why use NAV?** By separating the analysis of the net value of the portfolio from the present value of future investment opportunities, investors are better able to value the entire entity. REITs happen to be one of the few investment vehicles that lend themselves well to an exercise of this sort, as the existence of an active and liquid market for real estate accords an opportunity to derive a reasonably precise estimate of the net value of in-place assets.

**The Link between NAV and Share Values:** The model generates warranted premiums to asset value by assessing each REIT on a variety of key variables. REITs that stack up well on these variables should trade at relatively large premiums to asset value (and vice versa). Franchise value, the most important of these variables, is objectively assessed by measuring the value creation track record for each REIT, although subjective input as to whether past performance is a good predictor of future performance also plays a big role. The other variables in the model include corporate governance, share liquidity, overhead and leverage. Warranted asset value premiums generated by the model are applied to our estimate of NAV to generate warranted share prices for each REIT.

**How We Use this Model:** At any given point in time, roughly 25% of the companies we follow are ascribed Buy ratings, 50% are rated as Holds, and 25% are Sells. Because of that discipline, the model is designed to provide relative valuation conclusions, and is neutral with regard to overall REIT valuations, as well as property sector valuations. While our NAV-based model is our primary tool for assessing relative valuations across companies, we use a Discounted Cash Flow (DCF) model as a back-up approach.

**Limitations:** We utilize other approaches toward assessing overall REIT valuation (see our REIT Pricing Thermometer, published each month in the Real Estate Securities Monthly) and property sector valuation (see Property Sector Valuation, published every six months). These other approaches are designed to help investors who are more focused on absolute valuation levels and/or relative valuations across property sectors.

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# ***Section One***

## ***Overview***

**Section One - Overview**  
**The Basics**

**Introduction**

Our NAV-based pricing model has served as our primary tool for valuing REITs since 1989. The model is based on the logic that REIT valuation can best be assessed by analyzing separately the two key components of value: 1) the net value of the in-place assets and 2) the present value of future investment opportunities.

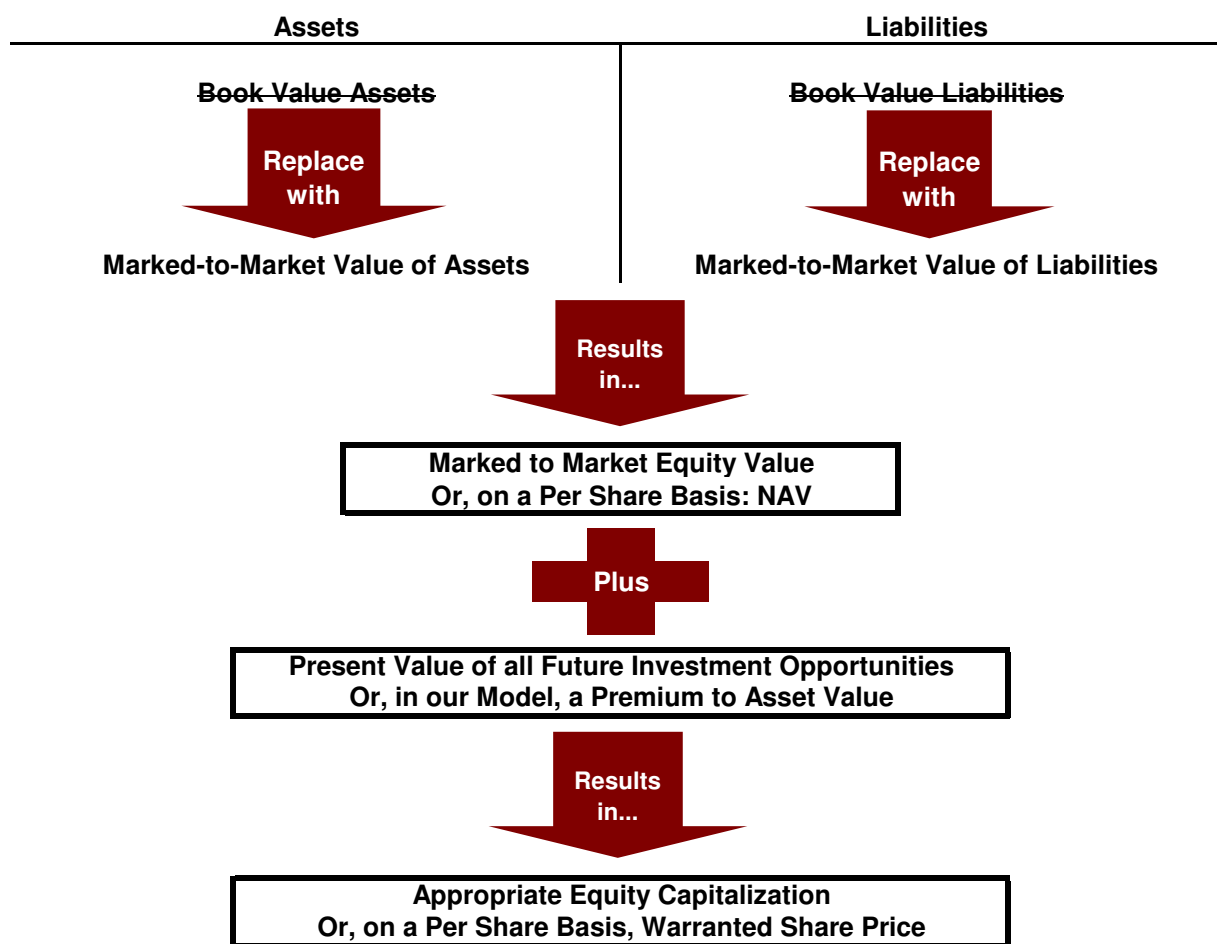
**The Model is Designed to...**

Identify the cheapest and most expensive stocks, measured on a relative basis, in each sector.

**Assumptions:**

Overall valuation of REITs, in aggregate, is appropriate.  
Valuation of each property sector is appropriate relative to other sectors.  
The value of any REIT can be calculated as follows...

**REIT Balance Sheet**



**Section One - Overview**

**A Step-by-Step Summary of How Our NAV-Based Pricing Model Works**

Our NAV-based pricing model takes a methodical and consistent approach toward valuing REIT stocks. Each of the primary steps outlined below is discussed in its own section of the report that follows.

**Step One - Calculate Asset Value and NAV**

For each REIT in our coverage universe, we do the following:

- Derive an estimate of marked-to-market asset value.
- Derive an estimate of marked-to-market liabilities.
- Compute NAV by subtracting liabilities from assets.

**Step Two - Determine the Appropriate Premium/Discount to Asset Value**

**Step 2A - Observe the magnitude of premiums in the marketplace**

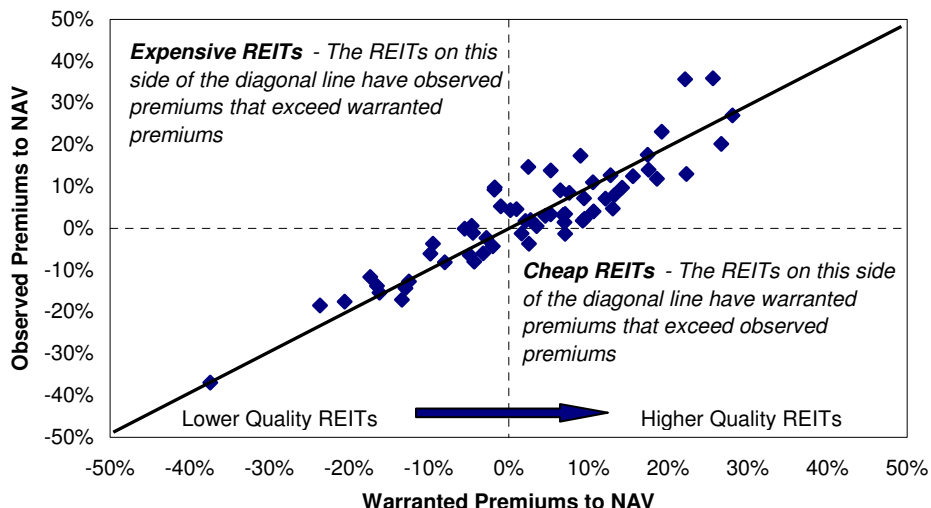
- Observe current share pricing of all REITs.
- Back into observed premiums to asset value for each REIT.
- Company-specific observations are aggregated to derive average observed premium for each property sector, as well as the dispersion of premiums around that average. A basic assumption of the model is that these aggregated premiums are appropriate at any given point in time, thus making the model both REIT-market neutral and sector-neutral.
- Use observed distribution (i.e. standard deviation) of premiums to ascribe REIT-specific warranted premiums in Step 2B.

**Step 2B - Derive Company Specific Warranted Premiums to Asset Value**

- Rank each company relative to peers with regard to variables that impact premiums to asset value. These variables include Franchise Value, Corporate Governance, Share Liquidity, Overhead & Leverage. Rankings are scored on a 100-point scale.
- Translate company-specific scores into warranted % premiums to asset value. High-scoring REITs are ascribed premiums approximating the largest observed premiums, while the inverse is true for low-scoring REITs.
- Convert warranted % premium to asset value into a \$-based Premium, and add to marked-to-market equity valuation. Convert to warranted share price.

**Step Three - Compare Warranted Share Prices with Observed Share Prices**

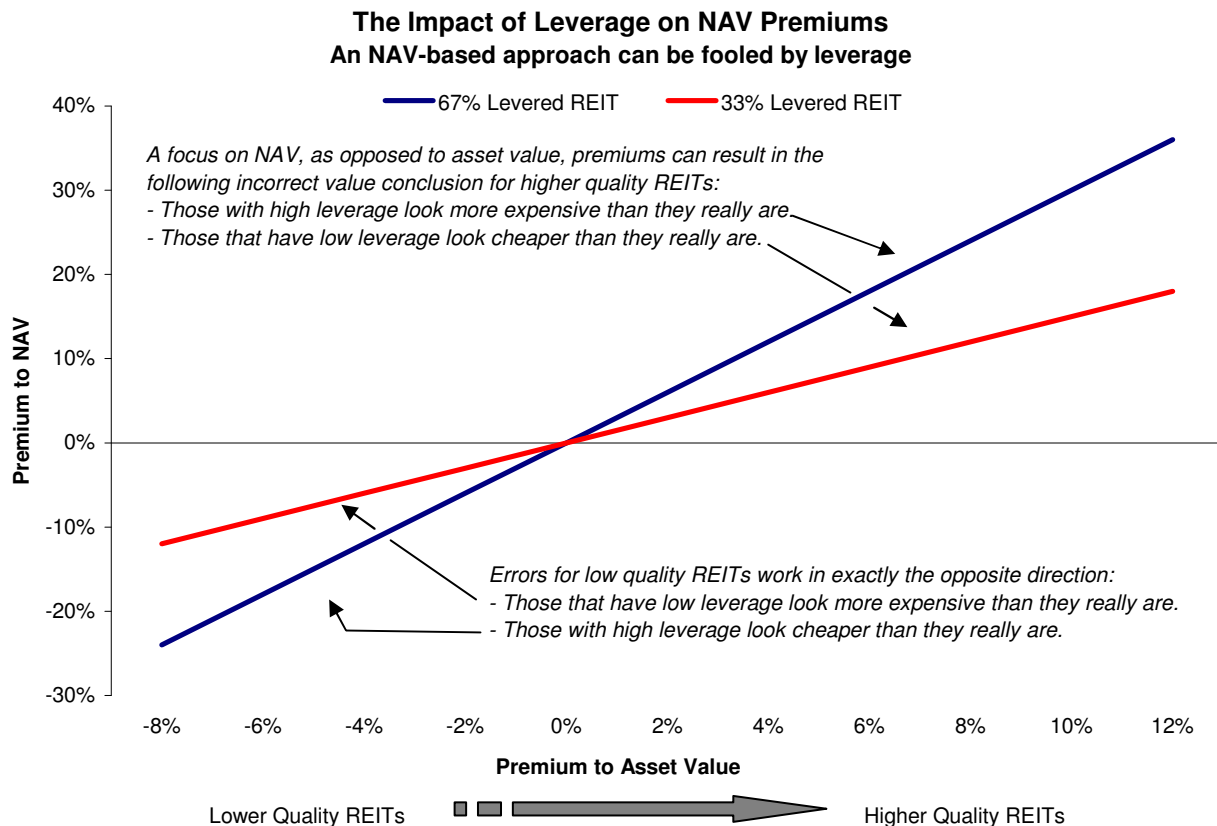
**NAV Premiums: Warranted vs. Observed**



**Section One - Overview**

**The Model is Based on Asset Value, not NAV**

**For most intents and purposes, leverage shouldn't impact value.** The value of investment opportunities varies according to the talent of a given management team and the environment in which it finds itself operating. The value of those opportunities is generally not impacted by leverage. However, as is highlighted below, premiums to NAV are materially impacted by leverage, creating the potential to be misled when focused solely on NAV premiums.



**Focusing on premiums to asset value, instead of premiums to NAV is consistent with Modigliani and Miller's Proposition I: A firm's overall value is independent of capital structure.**

**Implications for REITs:**

- 1) The biggest "real world" limitation to M&M's thesis involves the tax shelter associated with debt. Since REITs aren't subject to corporate tax, they're not impacted by this limitation. M&M's thesis on capital structure should be particularly relevant in the REIT sector.
- 2) The size of the premium to asset value should equate to investors' expectations of the present value of future investment opportunities. This present value is contingent on the volume of investments to be made in the future (i.e. a bigger dollar premium is possible where large external investments are being made) and the extent to which the returns on these investments exceed the appropriate cost of capital. Leverage has no impact.

## ***Section Two*** ***NAV***

**Section Two - NAV**  
**Calculating NAV - A Simplified Example**

Balance Sheet for REIT XYZ (X's \$1,000)

	<u>Book Value</u>	<u>Analyze Market Value and Replace</u>	<u>Current Value</u>
<b>Real Estate Assets</b>			
<b>Operating Real Estate</b>	\$8,500,000	———— A —————>	\$9,350,000
<b>Construction in Progress</b>	\$500,000	———— B —————>	\$2,250,000
<b>Land</b>	\$200,000	———— C —————>	\$170,000
<b>Equity in Unconsolidated JVs</b>	\$1,000,000	..... D .....	\$0
<b>Value of Fee Businesses</b>	\$0	..... E —————>	\$800,000
<b>Other Assets</b>	\$100,000	———— F —————>	\$70,000
<b>Total Assets</b>	\$10,300,000		\$13,290,000
<b>Liabilities</b>	\$5,000,000	———— G —————>	\$5,250,000
<b>Preferred Stock</b>	\$500,000		\$500,000
<b>Shareholders Equity</b>	\$4,800,000		\$6,040,000
Fully Diluted Shares	200,000	———— H —————>	204,750
<b>NAV</b>	\$24.00		\$29.50

**The Adjustments:**

- A. Operating Real Estate:** Usually the most important part of an NAV analysis. A 12-month look-forward estimate of NOI is calculated, the magnitude of an appropriate cap-ex reserve is determined, and an appropriate cap rate is applied to economic NOI (NOI less cap-ex). The quality of the analysis rests on an in-depth knowledge of prevailing cap rates, the appropriate cap-ex treatment for each REIT, and other required industry- and company-specific adjustments (e.g. seasonality, one-time items, etc.).
- B. Construction in Progress:** CIP can be worth well in excess of book value if projects underway appear headed for success. The inverse can also be true.
- C. Land:** Land values can be much higher or lower than book.
- D. JV Accounting is a Mess:** Because of that, we present a pro-rata allocation of assets and liabilities. There is no reliable way to otherwise value JV interests, as leverage within the JV typically renders more simplified approaches useless. A pro-rata allocation also does a much better job of showing leverage that may be embedded, but otherwise hidden, in JV investments.
- E. Fee Income:** REITs are increasingly generating asset management/property management fees associated with JV structures. This fee income can be lucrative, and the range of appropriate multiples to apply is dependent on the quality of the fee stream. This value is not reflected on GAAP balance sheets.
- F. Other Assets:** REITs often have a material amount of intangible assets, which are deducted for this exercise.
- G. Liabilities:** Mark to market adjustments are necessary where: subsidized financing is present, or market interest rates are materially higher or lower than contract rates on the REIT's debt.
- H. Fully Diluted Shares:** Ensure that all in-the-money options, converts, etc. are included in the share count.

## **Section Two - NAV** **Issues in Deriving NAV**

### **Valuing the Real Estate Portfolios**

The success of an NAV-based valuation approach is contingent on the quality of the estimate of the value of the real estate portfolio. Our approach involves a large amount of due diligence - both in the field and at our desks.

**Capitalization of Real Estate NOI - the most common approach toward valuing real estate.** This valuation approach applies a cap rate to the estimated 12-month forward property-level net operating income (NOI) generated by a REIT's portfolio. There are numerous adjustments that need to be made to numbers pulled from both the income statement and balance sheet when utilizing this approach, but they're generally straight forward. There are, however, two areas where extreme caution is warranted.

#### **1) Cap Rates: Where do they come from?**

Cap rates are the most critical input in an NAV analysis and the most subjective one. The quality of an NAV analysis is only as good as the quality of this input, and a substantial amount of work is involved in getting the cap rate call right. A broad sense of appropriate cap rates can be obtained by talking to market participants (e.g. brokers, real estate execs), but a detailed understanding of submarkets is important. Property visits are critical. Just as important is an understanding of existing lease structures. Unique lease structures can result in the use of very different cap rates for otherwise identical properties.

#### **2) The Cap-Ex Landmine - Don't let it blow up your NAV analysis**

Because many of the true costs of owning a portfolio of real estate are capitalized, not expensed, reported real estate NOI almost always dramatically overstates the true operating profit generated by that portfolio. A thorough understanding of the magnitude of those costs is necessary. Otherwise, an incorrect estimate of NOI will translate into an incorrect assessment of value. The problem is made worse by the fact that cap-ex reserves are far from generic, even among companies in the same property sectors. Accounting policies can vary hugely by company, and they must be well understood in order to derive a good estimate of NAV. In addition, cap-ex requirements can vary hugely due to differences in property quality, age, location, etc. Shortcuts on cap-ex will result in NAV estimates full of errors.

**Other Approaches Toward Valuation Should be Considered.** We use them when appropriate.

- 1) Value per square foot (especially interesting for office and industrial properties)
- 2) Replacement Cost
- 3) Discounted Cash Flow/Internal Rate of Return
- 4) Building-by-building Analysis

### **Marking to Market Liabilities**

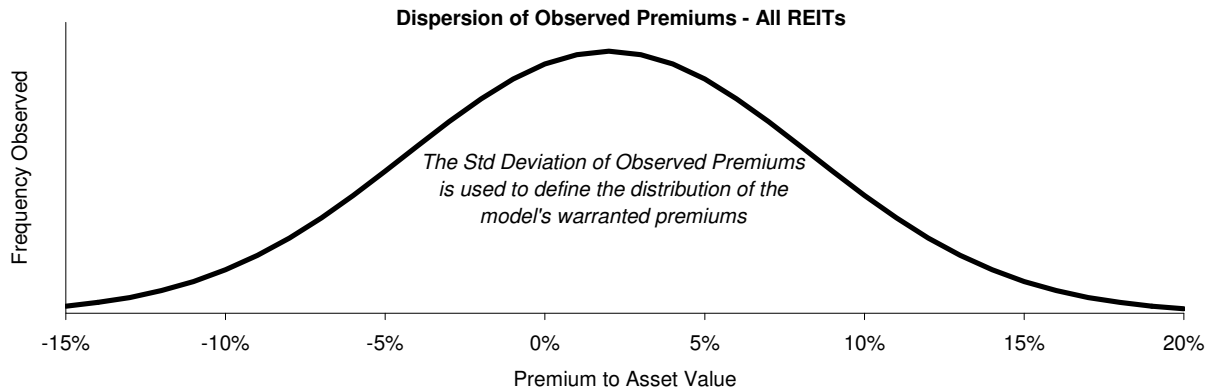
An oft-overlooked, but important, aspect of computing NAV is marking to market the right hand side of the balance sheet. Two REITs that are otherwise identical except for the fact that the debt of one is all at market rates, while the debt of the other is substantially above market, should trade at very different share prices.

## ***Section Three***

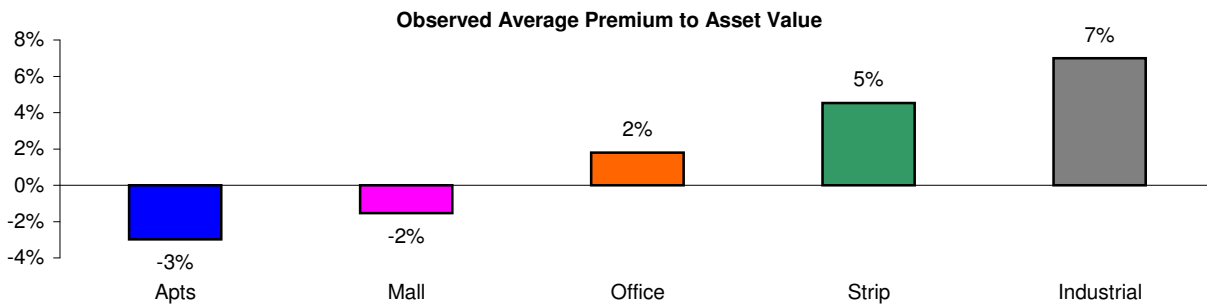
### ***Applying the Model***

**Section Three - Applying the Model**  
**Observe Prevailing Premiums**

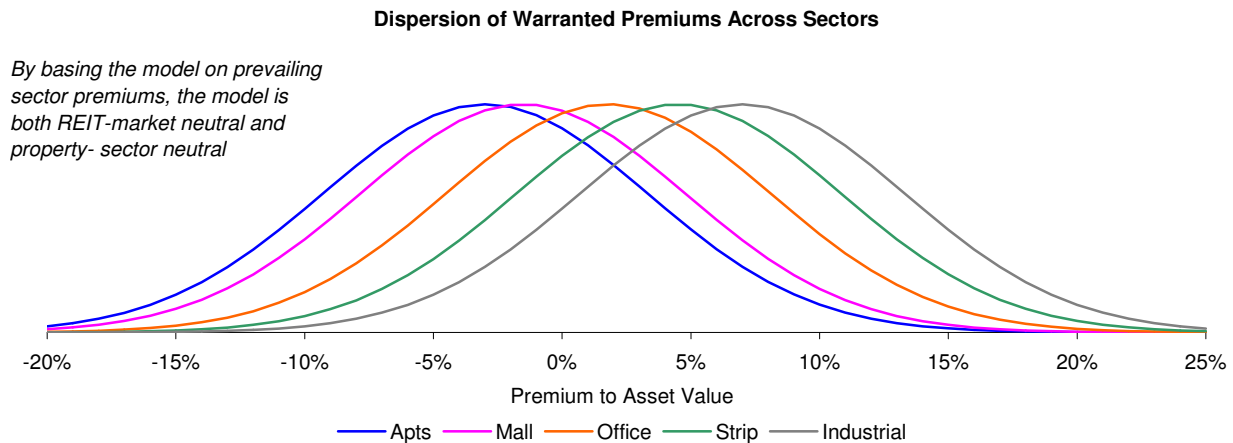
Observed premiums to asset value tend to be patterned along a normal distribution for a large universe of REITs in a variety of property sectors. We assume that both the average premium accorded by the market, and the degree of dispersion in observed premiums are appropriate.



Property sector influences tend to be strong - each major sector has its own unique distribution of observed premiums. Variances in average premiums across sectors are explicitly addressed in our model by using the sector-average premium as the base for calculating warranted premiums of companies in a given sector. In the example below, an average industrial REIT would warrant a higher premium to asset value than an average residential REIT because that is the way those sectors are currently priced in the market.



The dispersion of prevailing premiums for all REITs is combined with the average premium for each sector to generate warranted premiums for companies within each sector.

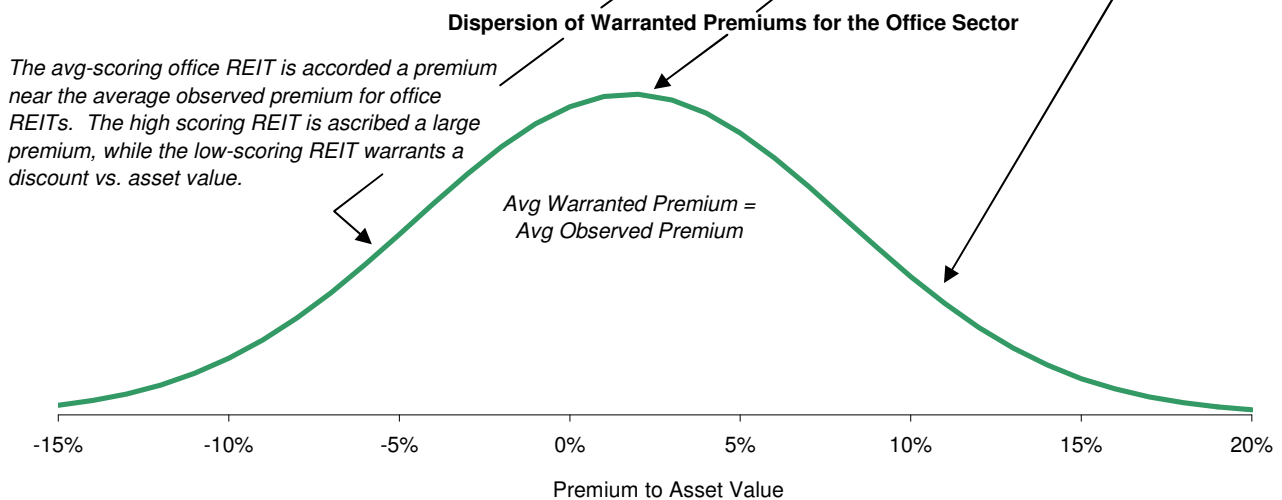


**Section Three - Applying the Model**  
**Assess the Ability to Create Shareholder Value**

Some REITs are deserving of bigger than average premiums to asset value (or smaller discounts), while others deserve relatively small premiums (or bigger discounts). The size of warranted premiums that are the output of our Pricing Model are dependent on the sum of the scores on each of the variables shown below. Franchise Value, defined as the ability of a management team to create value, comprises 60 of the 100 available points. The variables that comprise the remainder of the scoring system are: Corporate Governance; Share Liquidity, Overhead; and Leverage (more detail is available on each of these inputs on page 16). The example below shows how several office REITs stack up as of Sept '05. These rankings are certain to change over time.

Pricing Model Components	Points Available	Office REIT Avg	Small Premium REIT	Avg Premium REIT	Big Premium REIT
Franchise Value					
Performance-based Components					
Beginning Premiums	20	10	7	9	16
Total Return Ranking	20	10	5	7	14
Current Value Net Income Ranking	20	10	5	13	17
Adjustments to Objective Ranking	0	0	0	0	0
Objective Franchise Ranking	60	30	17	29	47
Subjective Components of Franch Val	0	0	5	0	0
Franchise Value	60	30	22	29	47
Corporate Governance	10	5	1	6	4
Share Liquidity	10	5	4	3	9
Overhead	10	5	2	8	9
Leverage	10	10	10	10	10
<b>Total Scoring of Model Variables</b>	<b>100</b>	<b>55</b>	<b>39</b>	<b>56</b>	<b>79</b>

The output of the scoring process is then statistically manipulated to fit the distribution of observed office REIT pricing (see prior page). While we effectively assume that the overall pricing of office REITs is appropriate, we are reascribing the premiums to asset value for each of the companies. Those we feel are best positioned to add value are accorded the highest warranted premiums, and vice versa.



**Section Three - Applying the Model**  
**Franchise Value - The Most Important Variable**

Managerial talent varies substantially from one REIT to the next. Some management teams have demonstrated a consistent ability to enhance shareholder value; others have weak track records. An assessment of these track records serves as an important step toward determining franchise value ratings. Franchise value is the most important variable in our model, as it comprises 60 of 100 available points. Here is how those points are objectively allocated:

**Total Return Track Record - 40 of the 60 Points**

**Step One:** Compare total returns (share price appreciation + dividends paid) for each REIT with the total returns generated by the company's property sector peers

Time Period	Total Returns			Score on 20 Scale
	1 Year	3 Year	5 Year	
Weighting	20%	30%	50%	
Stellar REIT	17%	12%	15%	17.1
So-So REIT	10%	8%	9%	10.0
Laggard REIT	13%	2%	2%	3.5
Sector Average	13%	8%	9%	

**Compare w/ peers; translate into 20 point scale** →

**Step Two:** Take into account NAV premiums at the beginning of those time periods. A company that has generated solid total returns despite starting at a rich premium is arguably more impressive than one that began the period with cheap pricing, and vice versa.

Time Period	Beginning Period Asset Value Premium			Score on 20 Scale
	1 Year	3 Year	5 Year	
Weighting	20%	30%	50%	
Stellar REIT	9%	6%	10%	15.6
So-So REIT	2%	5%	7%	10.3
Laggard REIT	-2%	1%	3%	4.2
Sector Average	3%	4%	7%	

**Compare w/ peers; translate into 20 point scale** →

**Current Value Net Income Track Record - 20 of the 60 Points**

Current value net income is defined as NAV growth + dividends over any time period. It serves as an excellent measure of performance and value creation. Comparing a REIT's track record in generating current value net income with that of its property sector peers adds insight regarding value enhancing capabilities.

Time Period	Current Value Net Income Change			Score on 20 Scale
	1 Year	3 Year	5 Year	
Weighting	20%	30%	50%	
Stellar REIT	15%	13%	17%	18.0
So-So REIT	9%	7%	8%	9.7
Laggard REIT	14%	0%	3%	4.3
Sector Average	13%	7%	9%	

**Compare w/ peers; translate into 20 point scale** →

**Compute Objective Franchise Ranking** - The sum of the objective components above results in the objectively derived franchise value ranking.

	Scores from Above				Objective Franchise Score		
Stellar REIT	17.1	+	15.6	+	18.0	=	50.7
So-So REIT	10.0	+	10.3	+	9.7	=	30.0
Laggard REIT	3.5	+	4.2	+	4.3	=	12.0

**Section Three - Applying the Model**  
**Franchise Value - The Most Important Variable (continued)**

Sometimes, a purely objective approach toward ascribing franchise value ratings works well; sometimes it doesn't. If managerial skill were the only thing that impacted performance and if it was always consistent over time, a purely objective approach would work well. However, because historical performance has also been influenced by factors that should not be extrapolated into the future (e.g. luck, a different management team, etc.), subjective inputs are often appropriate. Ascribing franchise values is part art and part science, and the portion that is art is addressed below.

*The simplest way to illustrate why subjective inputs are an important part of ascribing franchise values is by way of example. Consider the following hypothetical REITs:*

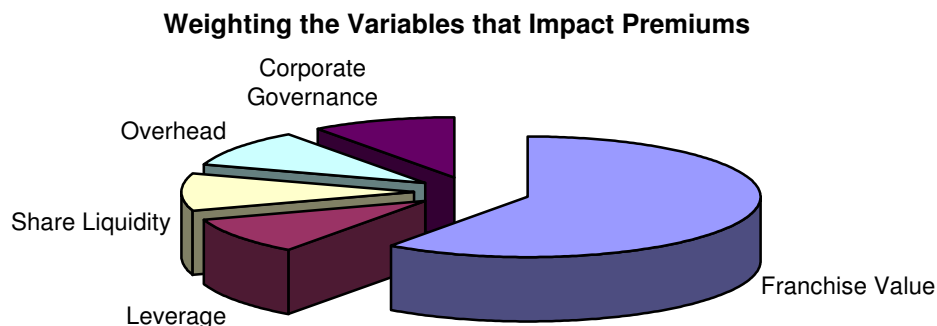
- **Lucky Gambler REIT:** Management believes it knows more about future interest rates than Bill Gross and has correspondingly financed its entire balance sheet w/ variable rate debt. In recent years, this has resulted in outsized returns and NAV growth.
- **Right Place at the Right Time REIT:** Despite mediocre management, company's long-time holdings of land in Coastal California and Mid-town Manhattan have resulted in extraordinary share price performance.
- **Black Sheep REIT:** Derelict son has recently taken reigns from brilliant father. Track record still looks good, but what happens next?
- **Bad Part of the Cycle REIT:** Having just experienced the sweet spot of the development cycle, this REIT has smartly pulled in the reigns as development has become less lucrative.

*The objective scores for each REIT might look something like what is shown below. The direction of appropriate adjustments is shown, though a determination of the appropriate magnitude of those adjustments requires experienced analysts.*

	<u>Objective Franchise Score</u>	<u>Direction of Subjective Adjustment</u>
Maximum Score	60	
Right Place at Right Time REIT	55	↓
Black Sheep REIT	45	↓
Bad Part of the Cycle REIT	38	↓
Average Score	30	
Lucky Gambler REIT	26	↓
Wrong Place at Wrong Time REIT	24	↑
Good Part of the Cycle REIT	10	↑

### **Section Three - Applying the Model** **The Other Variables in the Model**

Because franchise value is the most important determinant of appropriate NAV premiums, it accounts for 60 of the 100 points in our model. However, other key traits also affect appropriate NAV premiums. The four variables discussed below account for equal shares of the other 40 points in the model.



#### **Corporate Governance**

The premise that good governance should result in a higher premium to asset value is self evident. The governance scores utilized in our pricing model flow directly from our proprietary corporate governance rankings that we have maintained since 2003. Our governance rankings are derived via a methodical review of numerous governance issues for each of the REITs under coverage. These rankings also are impacted by our assessment of past conduct, a critical input that other ranking services are forced to ignore. A brief summary of the variables comprising our governance rankings is shown in Appendix C.

#### **Overhead**

Another self-evident premise is that a REIT with high G&A deserves a lower premium to asset value than one with a lean operation. Real estate NOI is an integral input in any NAV calculation, but because this figure comes above the G&A line on an income statement, G&A needs to be dealt with separately. Accounting practices regarding allocation of overhead as either an operating cost or G&A can serve to skew the results of an NAV calculation, but the inclusion of overhead as a separate variable in the model adjusts for that. We focus on G&A as a percent of marked-to-market assets for the sake of measuring overhead, similar to an expense ratio for a mutual fund.

#### **Share Liquidity**

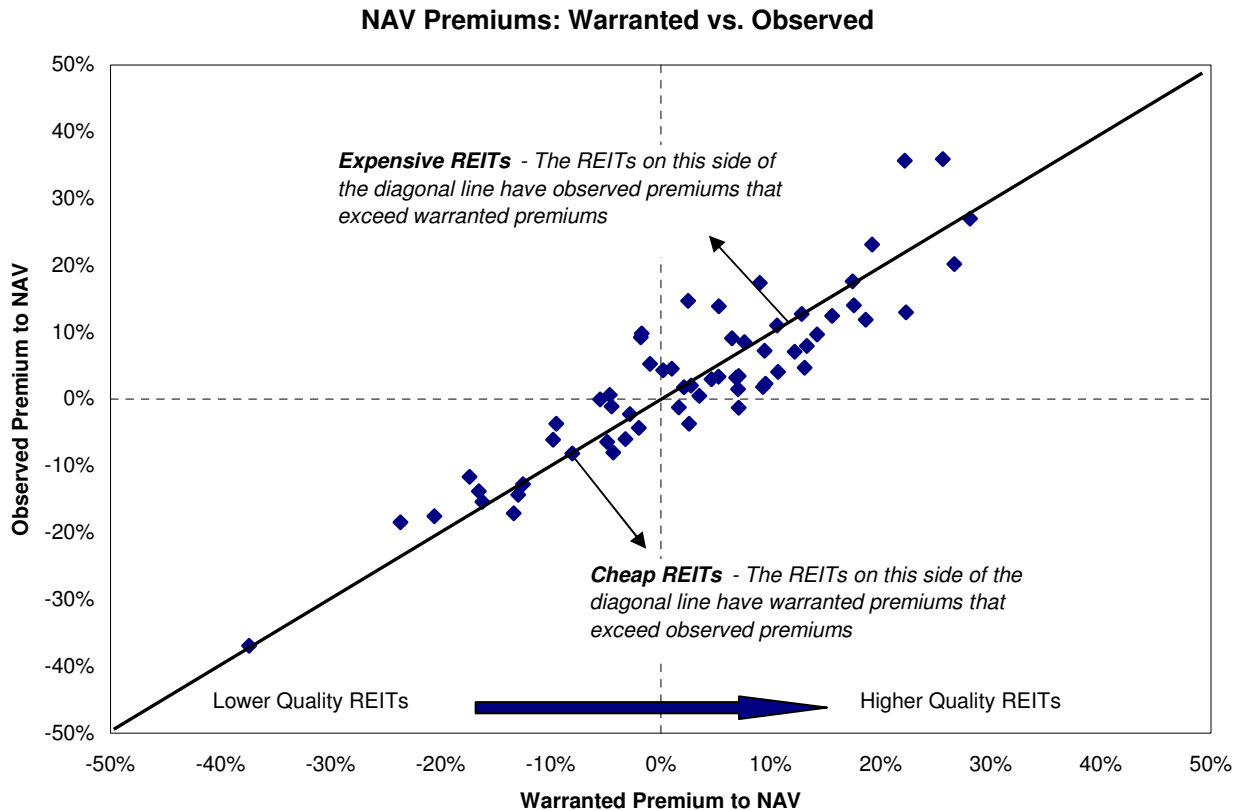
All else equal, REITs with liquid markets for their shares should be worth more than those with low liquidity. This view is consistent with academic literature suggesting costs of capital are higher for firms with very small market capitalizations. It is also consistent with observed pricing patterns in the REIT sector, as share liquidity has respectable explanatory power as a determinant of asset value premiums.

#### **Leverage**

For most intents and purposes, leverage has no impact on the size of premiums to asset value. There is no compelling reason why a REIT with, say, 30% leverage should trade at a different premium than one with, say, 55% leverage. Leverage can, however, impact appropriate premiums when it is so high that it might constrain managerial flexibility, and our model takes this into account. Most REITs are awarded 10 points on this variable, but fewer points are awarded REITs with debt > 65% of assets and no points are awarded those where this ratio is > 75%.

**Section Three - Applying the Model**  
**Interpreting the Output of the Model**

The warranted premiums to NAV generated by the model can be compared directly to observed premiums to NAV\*. Instances where observed premiums substantially exceed warranted premiums are suggestive of an overly rich share valuation. Instances where warranted premiums are much larger than what is observed are indicative of a cheap stock.



\*The model actually generates warranted premiums to **asset** value, and these are compared to observed premiums to **asset** value. The directional conclusion - i.e. a REIT is pricey or cheap - is identical whether the comparison is made based on premiums to asset value or premiums to NAV, but the magnitude of any mispricing can be skewed by leverage in an analysis focusing on NAV premiums.

**Translating the Output Into Recommendations:**

Our method is explicitly REIT-market and sector neutral. Companies in the top 25% of their property sector peers in terms of warranted price > observed price are typically accorded Buy ratings. Those in the bottom 25% are ascribed Sells, and the half in the middle get Holds. We occasionally deviate from this mechanical rating system.

## Appendix A Answers to Frequently Asked Questions and Criticisms

***Q. NAV estimates are far from precise. It's very common to see NAV estimates for a given REIT spanning a very broad range, with some being as much as 30% higher than others. Why base a model on such an imprecise estimate?***

A. NAV is admittedly an imprecise estimate of value. It may be better to think of NAV as the midpoint of a reasonable range in which a figure at least 5% higher or lower than the mid-point might be accurate. Reasonable minds can certainly disagree within this range.

However, this lack of precision should not be viewed as a serious shortcoming. After all, every valuation methodology lacks precision, and alternative methodologies are almost certainly less precise than NAV. Where do appropriate P/E multiples come from? EBITDA multiples? An NAV-based approach componentizes the valuation question into discreet pieces and incorporates private-market pricing information, attributes that should yield a higher level of precision than a broad-brush approach to entity valuation.

Finally, the fact that some analyst estimates of NAV fall well outside a reasonable range is probably more a reflection on the quality of the analysis, as opposed to the quality of the metric. NAV calculations require a great deal of time, energy, and expertise to get right, and big errors are likely when shortcuts are taken.

***Q. NAV is a backward looking metric.***

A. Real estate markets are active and liquid, and when buyers and sellers agree on deal terms (e.g. cap rates, price/sf, etc.), those terms are certainly reflective of their views of future prospects. When prevailing cap rates are applied to a REIT's forward looking NOI estimate, the result is an estimate of value that is as forward looking as any other approach toward valuing stocks.

***Q. As the REIT industry continues to mature, analysts and investors will inevitably value these stocks the same way the vast majority of other stocks are valued. Approaches based on P/E multiples, EBITDA multiples, or DCF models will take the place of a REIT-centric concept like NAV. After all, no one tries to figure out the NAV of GM or Microsoft, so why bother to do so with REITs?***

The simple answer to this question is that investors in other sectors would use NAV if they could. However, their inability to do so relegates them to using metrics that are generally inferior.

Thoughtfully applied alternative approaches to valuation should result in similar answers to an NAV-based approach, but these other methods have to be used with caution. We utilize a discounted cash flow (DCF) approach as a secondary valuation tool, and it normally provides an answer quite close to the output of our NAV-based approach.

***Q. REITs are more than just a collection of assets. Management matters a lot, and an NAV-based approach can't possibly factor that in.***

A. Contrary to a widespread misperception, the use of an NAV-based model is by no means inconsistent with a view that management is important. As long as an NAV-based model provides output with a sizable variance in company-specific warranted premiums/discounts, that model is implicitly acknowledging that management matters a lot.

***Q. Many REITs own hundreds of properties spread all across the country, and an asset-by-asset appraisal would take an enormous amount of time. How can an analyst pretend to know the value of any given portfolio?***

A. A reasonable NAV estimate can be derived if disclosure at the portfolio level is sufficient to allow for a comparison of the characteristics of a given portfolio with the characteristics of properties that have traded hands. No two portfolios are exactly the same, but plenty of pricing benchmarks exist to allow for adjustments based on portfolio location, quality, lease structure, growth prospects, etc.

***Q. An NAV analysis is only as good as the cap rates applied to NOIs. Where does Green Street get its cap rates?***

A. The choice of cap rates is the most important input in our model. Our analysts spend a great deal of time talking to market participants (e.g. REIT execs, private real estate participants, brokers, etc.), compiling databases of comparable transactions, reading trade publications, reviewing findings of providers of cap rate information (e.g. Real Capital Analytics), and understanding the extent to which contractual rents are above or below market.

***Q. REITs have broad latitude in how they expense many operating costs. Can't an NAV-based approach be fooled if a REIT goes NOI by moving costs to the G&A line?***

A. Yes. This is why an explicit valuation adjustment for G&A expense is included in our model.

***Q. An NAV analysis derived from real estate NOI seemingly ignores capital expenditures (cap-ex). How does cap-ex factor into the analysis?***

A. One of the easiest ways to make big mistakes in an NAV analysis is to utilize simple rules of thumb with regard to cap-ex. In addition to the fact that most rules of thumb undercount the magnitude of cap-ex, the range of appropriate reserves varies hugely by property sector, property quality, and accounting practices. Each of these factors needs to be addressed before choosing the cap-ex reserve to utilize for a particular portfolio.

The real estate portfolios in any sector that offer the highest quality, best growth, and lowest risk should be accorded the highest valuation multiples (lowest cap rates), and vice versa. It is thus important to rank the portfolios relative to each other, and to then ensure that "economic" cap rates (based on NOI less a cap-ex reserve) line up in this manner. An analysis that does not back out cap-ex costs, and is instead based off of nominal cap rates, will generate misleading relative conclusions.