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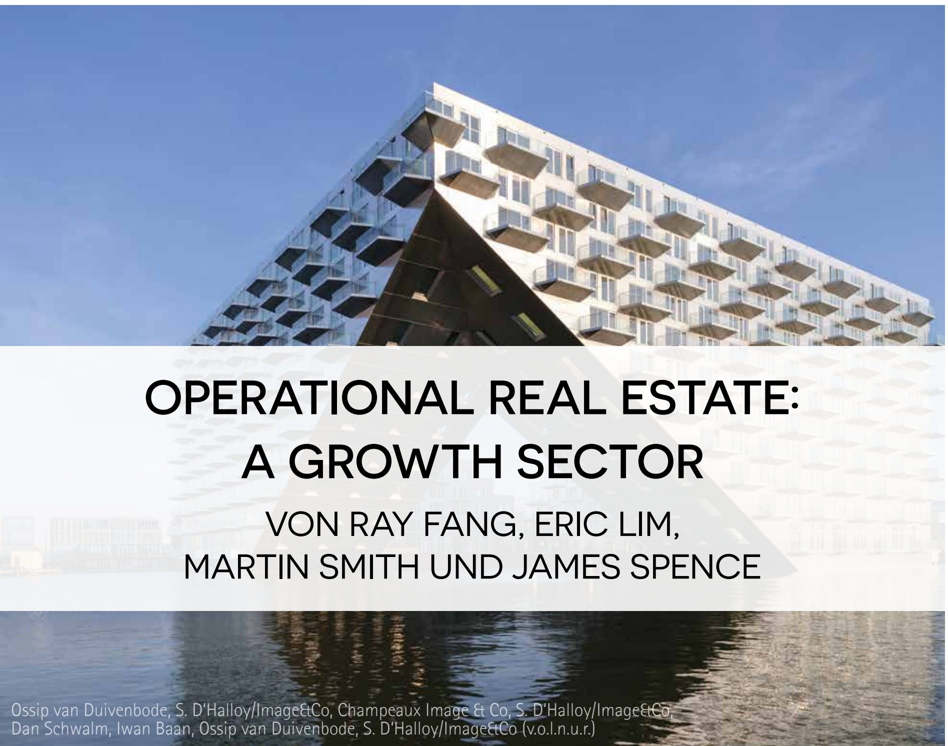

OPERATIONAL REAL ESTATE: A GROWTH SECTOR

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OPERATIONAL REAL ESTATE: A GROWTH SECTOR

Structural economic and consumer changes are altering occupational demand, causing real estate to become more dynamic and operationally intensive. This is increasing interest in operational real estate investment opportunities, presenting both challenges and advantages for investors seeking to build solid and diversified investment portfolios. The UK Investment Property Forum defines operational real estate as "real estate investment where the return is directly and deliberately linked to the revenues and profits of the business conducted on or from the premises". Once a niche segment, operational real estate is becoming mainstream for several reasons. First of all, the appealing income profile and strong structural fundamentals within sectors that typically offer an operational model, such as hotels, care homes, residential or, self-storage, attracted interest. Secondly, shorter lease terms show rising demand for more flexible, service-led options. As a result, landlords must become more attentive and increase operational intensity to preserve income streams. This has narrowed the gap between traditional leasing models and operational real estate. Finally, innovative disruptors, such as flex office providers offering amenities and "on-demand" space, led to the emergence of operational models across all sectors. This article provides a good overview of where opportunities lie, in addition to what investors need to look out for as well. Red.

One of the most significant recent trends in the UK and wider European and global real estate markets has been the rapid growth of the operational real estate sector. Operational real estate, which covers a range of asset classes/sectors, increasingly attracts interest from a diverse group of investors. This article will look at:

1. What is operational real estate and how does it differ from more traditional asset classes?

2. What is driving the growth of investment in operational real estate? Why is it attractive to investors and operators? How are the demands of users/occupiers fuelling growth?

3. What are the key challenges facing real estate investors looking to move into operational real estate? How do operational real estate sales/purchases differ from other real estate transactions? What are the additional complexities of owning and managing operational real estate?

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Operational real estate (ORE) can mean different things to different people but the term is broadly understood to refer to real estate investments where the returns on such investment are directly and deliberately linked to the financial performance of the business conducted on or from property, in contrast to a traditional leasing model.

Operational real estate and traditional asset classes

ORE is typically associated with alternative or non-traditional real estate sectors and, historically, has been seen as high risk, complex and opportunistic when compared to traditional asset classes. Hotels is one obvious example of ORE – the entire tenant base vacates on a daily basis and generating revenue relies, in the majority of models, on providing more than just a room and a bed; hotel investment has therefore been seen, until relatively recently, as something of a specialist area.

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However, ORE deal volumes and allocations are increasing as a broader range of investors seek to include this type of investment in their portfolios, attracted by the opportunity ORE offers to capture the extra upside associated with a successful operating business. As the growth of ORE investment continues, there has been a steady increase in allocations by investors to the following sectors: specialist residential (PRS/multifamily); purpose built student accommodation; senior care; hospitals and medical practices; life sciences and laboratories; serviced offices; car parks; data centres; self-storage; hospitality and leisure (including holiday parks, cinemas, pubs, marinas); and TV/film recording studios. Increasingly, ORE investments will offer mixed use products, blurring the lines between asset classes – for example in live/work developments.

Growth drivers and attractiveness

Users/occupiers of real estate are increasingly demanding more from their property, especially in a post-COVID-19 world; they want flexibility, plus additional facilities and services, not just four walls and a roof. This trend can take many forms, whether it be: individuals looking at new ways of living and working (remotely); businesses trying to encourage employees to return to work and needing to provide best in class working environments to retain staff; hotels looking to flex their space by offering rooms as temporary offices; or combinations of various different users.

These demands are driving fundamental changes to occupier/guest/user expectations of services delivered as part of their property/accommodation requirements and the ways in which they are provided. All types of users are starting to view property occupation as buying a service, rather than simply acquiring a space in a building, which in turn is helping to drive the demand for, and consequently the investment in, ORE assets and businesses.

This growth presents more opportunities for the significant number of investors seeking exposure to the ORE space. One of the drivers for this demand is that ORE is seen as offering higher returns than many traditional real estate investments, especially given the very low yields recently available in sectors such as core offices and the fierce competition in higher performing sectors such as logistics. Those returns are a function of the operational nature of the business/income stream relating to the underlying real estate carrying greater risk and, therefore, demanding greater reward than the traditional model of holding and leasing property.

Alongside the growth in investors looking for ORE opportunities, the market has seen a similar growth in specialist teams holding themselves out as operators and/or managers. Many manager platforms are founded around one key individual (or a small group) with valuable experience in the relevant sector but often with limited financial resources. The increased investor appetite for ORE assets has allowed a greater number of managers to find, and partner with, capital providers in order to start, develop and grow successful ORE businesses.

Other factors that attract investors towards ORE investments include: economies of scale to drive efficiencies and value creation (being a key driver for private equity investors engaged in "buy and build" portfolio strategies); the opportunity for diversification of income streams, lease structures and property types; and the limited availability of core/traditional real estate investments in a competitive investment market.

Key challenges

Whilst there are a variety of pull factors that attract investors to make ORE investments, there are also some challenges.

For many real estate investors, especially those transitioning from traditional real estate investments into ORE, one of the key factors to success is partnering with the right operating partner and/or management team and appointing them on the right terms. ORE is by its very nature, management intensive; many institutional investors do not have the in-house capability (in terms of staff numbers or expertise) to be able to design, deliver and manage ORE businesses day to day and so most rely on third party managers. As the ORE market continues its rapid growth, the relationship between investors and operators/managers will be key to delivering success. Such growth presents opportunities for both parties but only if you get your relationship right.

Another key challenge relates to the underwriting of ORE investments. There can sometimes be a lack of clarity and consistency regarding how to approach the issue of risk when pricing ORE assets. Investors need to be mindful that the risks associated with underlying property assets are very different from those attached to the competency of an operator/manager and the stability of business cashflows.

Investors will often need to undertake a detailed examination of an ORE business' revenues, costs and profits in order to understand its business model, the relevant operational sector and track record in delivering cashflow. The need to undertake greater operational and financial due diligence when investing in ORE can lead to small ticket operational assets becoming less liquid and can result in ORE transactions being weighted towards large single assets and portfolio deals.

Unlike most traditional real estate transactions, an ORE deal is also more complex, involving the purchase of a target corporate structure owning all assets required to operate the business at the property – in addition to the underlying real estate, this may include the benefit of employees, intellectual property and material business contracts. An ORE purchaser will also inherit all liabilities (both known and unknown) of the target, including operating liabilities relating to employment and pensions, litigation, regulatory breaches and tax. This creates additional transaction risks, requiring a broader degree of legal, tax, accounting and commercial due diligence.

For example, key considerations may include:

- Employees: often essential to the ongoing smooth running of the business. Employment contracts need to be reviewed and transfer regulations considered. Issues such as minimum pay regulations, pensions, holiday pay, bonuses/ incentive schemes all need to be diligenced. If the acquisition is to be merged into an existing platform/business and not all existing employees are to be retained, then redundancy processes and costs need to be factored in.

- Intellectual Property: often attracting occupiers to an ORE site will rely on brand recognition. Does acquiring the existing business give you the rights to the operating brand? Not always. Are brand names, logos, et cetera appropriately protected? Is IP owned by the business or by the third party operator or a franchisor? Do the activities of a business infringe any IP of any third party?

- Data Protection: customer list and contact details can be a valuable part of an ORE business, but who owns them - the ORE investor or the manager/operator? If data has not been appropriately gathered or protected then acquiring the existing business may bring substantial liabilities.

There are many more layers to an ORE acquisition than to buying just the underlying real estate and many more pitfalls for investors taking their first steps into the world of operating businesses.

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