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RESEARCH

Operational Real Estate: Risk And Reward

SUMMARY REPORT

COMMISSIONED BY THE IPF RESEARCH PROGRAMME

This research was funded and commissioned through the IPF Research Programme 2018–2021.

This Programme supports the IPF's wider goals of enhancing the understanding and efficiency of property as an investment. The initiative provides the UK property investment market with the ability to deliver substantial, objective and high-quality analysis on a structured basis. It encourages the whole industry to engage with other financial markets, the wider business community and government on a range of complementary issues.

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Operational Real Estate: Risk And Reward

Report

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OVERVIEW

Operational real estate (ORE) is currently most associated with alternative real estate types, such as filling stations, GP practices, hotels, PRS, pub chains, self-storage and student housing, as opposed to more traditional sectors, such as office, industrial or retail property.

For many investors, ORE has been viewed as complex, illiquid and opportunistic; however, deal volumes and allocations are increasing. Investors are attracted to this type of investment as it offers an opportunity to capture the extra upside associated with a well-run business or a newly emerging business model. Demand for high quality, recurring, long-term income coupled with a relatively attractive yield profile and the ability to actively manage the assets are also contributing factors.

At the same time change is occurring in the traditional investment types of retail, office and industrial property. For example, flexible office leasing models may enable investors to have a direct relationship with an operator while structural change in the retail sector has provoked a greater consideration of direct relationships with brands.

However, there is a lack of clarity in how to address the issue of risk when pricing operational assets. Therefore, there is an inconsistency in approach, exacerbated by the use of non-standard models to make real estate investment decisions more generally. This was explored in the IPF's hurdle rates paper of 2017, which found:

1. It was common practice among commercial real estate investors in the UK to use decision-making tools other than cash flows in the investment process;
2. There was significant evidence of discretionary behaviour being exhibited by real estate investors in the appraisal process, which resulted in inconsistencies in the use of key metrics in the decision-making process; and
3. There was also a reluctance to adopt more sophisticated quantitative modelling applications.

There are many attributes important to assessing risk in ORE that may be unfamiliar to real estate professionals, for example understanding the key components of corporate accounts relevant to the property owner's investment. The uncertainty and inconsistency in this area may affect the liquidity of such assets and, therefore, price transparency.

Research Objectives

The objectives of this study are:

1. To provide the reader with a clear definition of what constitutes operational real estate, how it differs from traditional real estate investment and why it should not be treated as a subset of the real estate "alternatives" universe;
2. To address how real estate investors assess and quantify risk when underwriting an ORE investment opportunity, starting with a review of which theoretical investment modelling techniques may be used in this process;
3. To examine what investment modelling techniques are currently adopted by investors when underwriting an ORE investment. Is there one predominant approach or many in use and why? This examination will draw on feedback from a survey of active pan-European ORE market participants, including fund managers, advisers, lenders and operators, and their experience of working in this sector, undertaken as part of this study;
4. To identify and examine any differences between the theoretical approach to underwriting ORE investments and compare those with current market practices in the sector; and
5. To identify potential gaps between theory and practice in assessing and quantifying risk in the ORE sector and recommend what should constitute best practice for investors and real estate practitioners.

Definition of ORE

ORE may be defined as a 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. ORE cannot be simply defined by physical characteristics and ORE can include traditional and alternative real estate asset types. A key feature of ORE is that an asset can move between the categories of traditional and operational real estate during its lifetime: for example, a hotel could be leased (traditional) and subsequently operated under a franchise (operational) at different stages in its investment lifecycle. At each transition, investors need to reappraise the risk and return characteristics of the investment.

Difference between ORE and traditional real estate

The value of traditional real estate assets is fundamentally dependent on the current and future income streams linked to the performance of a property sector and specific location. There is a degree of contractual certainty given by leases and rent reviews, although specific risks remain around tenant (business) failure and temporary voids.

For ORE on the other hand, returns are more directly dependent on the operation of the business carried out within the building. Investors' expected returns from a hotel, say, may be based on the operator's performance through a management contract and, therefore, the business component of the future income flows is critical. However, in choosing to invest, due regard will be given to the covenant and skill of the operator, as well as the investment characteristics of the property and its location.

In traditional real estate the landlord and tenant are linked by a lease whereas in ORE there are four distinct operating models used by investors in ORE: hybrid lease; franchise; management contract; and owner/operator. These operating models are defined below:

(i) Hybrid Lease

These leases vary considerably but their common feature is that all or part of the rent is based on an agreed percentage of turnover or profit. The investor's return is intentionally linked to the underlying business. These leases, commonly known as hybrid or turnover leases, are used increasingly within the retail sector.

(ii) Franchise

Under this scenario, a franchisor can license its know-how, procedures, intellectual property, brand, and rights to sell its branded products and services to a franchisee. This model is widely used in the automotive, hospitality, leisure, professional services and retail sectors.

(iii) Management Contract

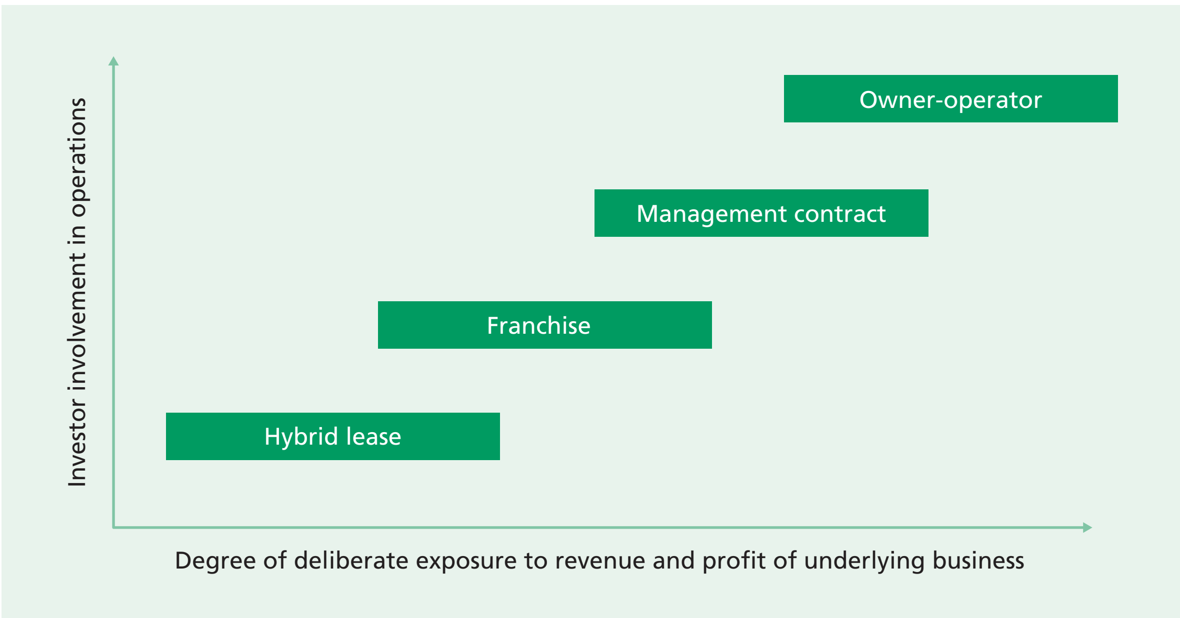
The investor engages the operator to operate and manage the property on the investor's behalf. As with the franchise, the investor is responsible for all operating costs and repairing liabilities and, therefore, carries the operational risk for the property.

(iv) Owner/Operator

Under this fully integrated model, the owner is the operator.

An investor's exposure to the risks and rewards of the operating business increases as it moves up the scale from a hybrid lease business model to owner/operator as shown in Figure 1.

Figure 1: Operating Models in the Hotel Sector



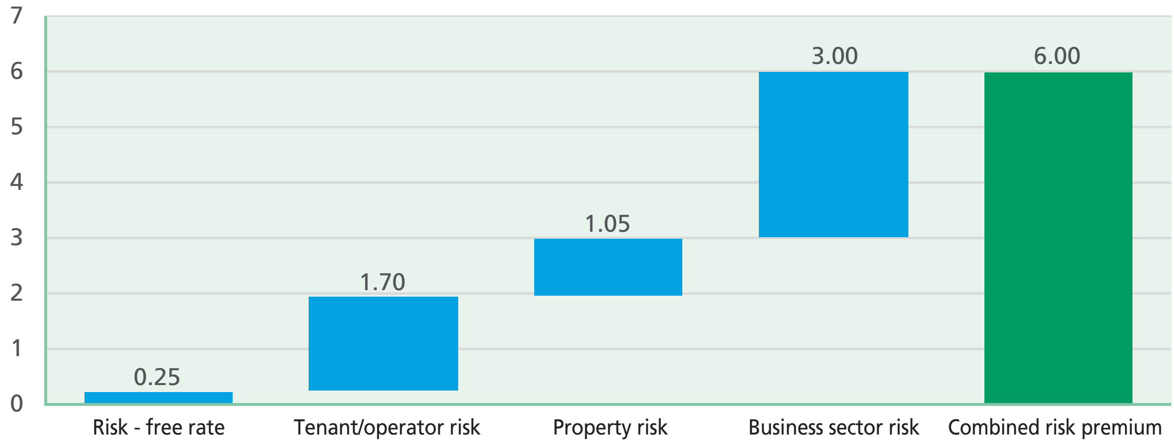
Source: Didobi 2020

Assessing and quantifying risk – the theory

The recommended model is to calculate net present values based on estimated cash flows, making sure to use a discount rate that adequately reflects the multiple risks facing an investor in ORE.

The waterfall chart, Figure 2, shows how this discount rate is built up. Beginning with the long-term risk-free rate, the investor adds three risk premia, one each for credit risk, property risk and business risk. This approach adequately reflects the risk associated with (a) the tenant/operator, (b) the property itself and (c) the nature of the business that is carried out on the premises.

Figure 2: Risk Premia based on underlying Hotel Asset



Source: Didobi 2020

Assessing and quantifying risk – the practice

Evidence gathered via a survey and structured interviews indicates that investors use a range of methods to appraise risk when underwriting ORE investments. However, no standard approach has been adopted across the real estate investment industry. When assessing risk, the focus is on economic and business risks and the variability of the operator's earnings, costs and revenues. When quantifying risk, investors focus on scenario/ sensitivity analysis and operator due diligence.

Potential gaps

The survey and structured interviews identified several gaps between the theory and practice including (i) under-analysis of the variability of cash flows and (ii) inappropriate application of the concepts of tenant, tenancy and rent.

On the first point, any estimation of the variability of cash flows from operational real estate requires a deep understanding of the operator's business, and this becomes more and more evident as the commercial relationship between owner and operator evolves from a traditional landlord/tenant one towards a business partnership. For example, in the hotel sector, estimation of cash flows to the investor requires a granular analysis of the hotel's business. Cash flows from rooms and from food and beverage departments should ideally be assessed separately rather than treating all such cash flows the same. Where the investor's return is linked to profitability as opposed to revenue, the investor needs to assess and quantify the tenant/operator's costs.

On the second point, there is a tendency to use the term 'tenant', regardless of the contractual arrangement that is in place or planned (e.g., a management agreement or franchise). The concepts of tenant and rent are very familiar but, when assessing and quantifying the risk in ORE investments, they can confuse the nature of the relationship between the two parties. Neither is apt when, for example, an investor decides to buy a hotel run under a hotel management agreement. Tenant fails to reflect the nature of the owner-operator relationship (they are business partners) while rent disguises the fact that the owner's income is by no means certain or fixed.

The gap analysis does not suggest the requisite skills do not exist in an organisation, but questions whether those skills are being utilised efficiently.

Best practice suggestions

To encourage industry discussion around this topic, the following guidance is offered to ORE investors:

- When undertaking an ORE investment appraisal, the risks associated with the physical asset from those attached to the skill of the operator and their ability to generate secure and sustainable cashflow should be separated;
- A close examination should be undertaken of the tenant/operator's revenues, costs and profits, including a detailed understanding of their business model, the sector they operate in and their track record in delivering cashflow;
- Data sources beyond the traditional real estate market should be sought to provide greater insights into the creditworthiness and operational skills of companies and individuals;
- The Net Present Value approach should be used to appraise opportunities;
- The discount rate used should adequately reflects the multiple risks facing an investor in ORE; and
- The skill base and financial knowledge within investment teams needs to be broadened and may require, where appropriate, the adaptation of risk modelling techniques used in the equity and fixed income markets.

The report finishes with some predictions, including one on recruitment. Increasingly, investors may see the need to recruit people with experience in the underlying business sector to work alongside their real estate professionals, something that is already happening in some of the larger investors and fund/investment management houses (for example, hiring people from the hospitality sector to work on hotel funds).

A second prediction in the report's conclusion concerns data. ORE is less mature than other forms of real estate and there are fewer readily available industry benchmarks and historic data series to draw on. However, there is plenty of data available on the underlying business sectors. Harvesting data from the bond and equity markets, from the representative bodies within each relevant business sector, from government sources and elsewhere will improve the risk analysis of ORE investors in the future.

The report includes a glossary and appendices comprising (i) a worked example of investment modelling (ii) survey evidence and (iii) a bibliography.

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