Operational Real Estate – Real Asset or Real Economy?
2020

Research

INREV is the European Association for Investors in Non-Listed Real Estate Vehicles. Our aim is to improve the accessibility of non-listed real estate vehicles for institutional investors by promoting greater transparency, accessibility, professionalism and standards of best practice.

As a pan European body, INREV represents an excellent platform for the sharing and dissemination of knowledge on the non-listed real estate industry.

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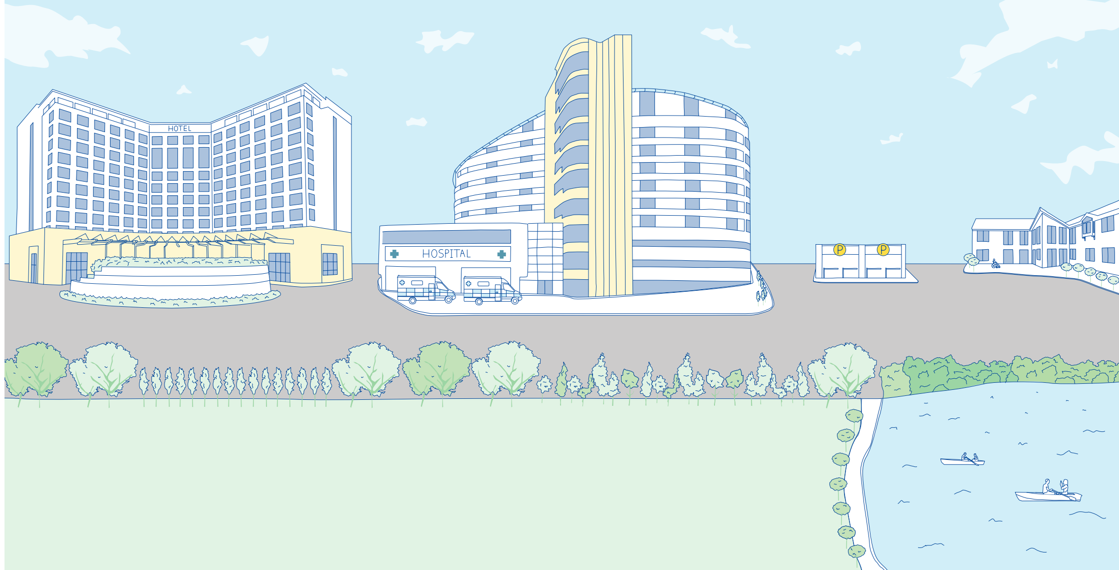
Contents



Executive summary

Operational real estate comprises a diverse range of sectors that are responding to the underserved demand stemming from accelerating economic and social megatrends. These opportunities span a wide range of both existing and new segments that share the characteristic of the occupying business being anchored to real estate, thereby elevating operational risk exposure.

This research explores the risk characteristics of the evolving operational real estate investment sectors in Europe and the implications for the investment approach in terms of objectives, structure, and resource requirements. It finds that the operational real estate landscape is very diverse and the degree of exposure to operational opportunities varies strongly between sectors and segments. This has a significant impact on the approach to investment. Each segment is driven by multi dimensional risk attributes including the stage of asset development, market maturity, variation in regulatory requirements and cultural approaches, and regional and local market dynamics.

This research is primarily based on 22 bespoke interviews, undertaken between June and August 2020 with investors and investment managers active in the alternative real estate market in Europe.

This complexity enables investors and managers to access a wide range of positions. The capacity to create bespoke risk exposures from a menu of risk and return attributes allows investors to tailor opportunities to their investment objectives, mandates and fiduciary duty. In addition to providing investment opportunities that are more dislocated from economic cycles, its range of income and growth characteristics makes it a good portfolio diversifier. It provides access to investments that can offer one of these three profiles: long term and stable income streams, strong income and capital growth, or variable income and capital growth.

Investing in operational real estate can also unlock the potential to develop and own the solutions required to meet the needs of the evolving new economy and society, not merely the real estate. Investors can choose whether to invest in real estate as a product, real estate as a product with a service, or real estate as a service. Indeed, the research finds that this trajectory towards a real estate product to service spectrum is accelerating for all real estate sectors, regardless of whether real estate is a core component of the occupier's business. Delivering space as a service either directly or indirectly through an intermediary may be essential to adding and protecting value. This is leading to a polarisation in investor mindset between viewing the investment opportunity as asset-based or considering the asset as providing an opportunity to invest in an economic growth sector.[1]

> 'The operational real estate landscape is very diverse and the degree of exposure to operational opportunities varies strongly between sectors and segments'

> 'Investors can tap into the underserved demand stemming from accelerating economic and social megatrends'

1 The primary research coincides with the period of intense lockdown directly impacting customer-facing businesses, especially hospitality and education. Interviewees considered that while this presents an economic shock to many operational real estate sectors in the shorter term, the scale of the opportunity in underserved markets persists beyond the horizon of this pandemic and therefore, it is not a focus of this report

Operational real estate investments can be structured in a variety of ways. The range of investment perspectives and risk positions is pivotal to determining investment structure. The three main options are to either separate real estate and operational entities, to enable limited participation in the operational income in addition to the real estate income, or to provide an opportunity to develop and grow a real estate anchored operational business.

Regardless of structure, the performance of the investment is dependent on its operational success. Investors and managers monitor the performance of the operational business throughout the life of the investment, building trusted relationships with their operators to effectively manage the asset. Investing in operational real estate sectors has implications for the required expertise, knowledge, and overall resource. The range and depth of this resource requirement intensify with the rate of participation in the operational business across the investment structures. These resource implications also have consequences for required investment scale.

Although the findings of this research are derived from a detailed analysis of the structure of operational real estate sectors, they are relevant to the wider real estate universe. Operational risk exposure is increasing across all sectors as business life cycles and lease lengths shorten. Understanding the drivers of the affordability model of underlying occupiers' businesses will be key to assessing affordable rents, estimating potential growth and managing risk.

Investment approaches and risk consideration are driven by how investors perceive the opportunity, which may be categorised into whether they adopt a real asset or a real economy mindset.

> 'The three main options are:
> - separate real estate and operational entities
> - limited participation in the operational income in addition to the real estate income
> - develop and grow a real estate anchored operational business'

> 'Implications for the wider real estate industry as business life cycles and lease lengths shorten and understanding the drivers of occupiers' affordability model becomes crucial in accurately assessing opportunities and risks'

Section 1

Introduction

Introduction

Investment appetite for operational real estate has increased significantly over the past ten years. Analysis of the INREV Fund Index indicates that growth in investment allocations in Europe to stand-alone operational real estate sectors, Residential and Mixed Use has outstripped that of Office, Retail and Industrial/ logistics, with current allocations at 11.8% and strong investment intentions to increase exposure.[2]

The risk premium associated with stable, often inflation-adjusted income from real estate investments has been beneficial to institutional investors attempting to satisfy asset-liability matching requirements in a low interest rate environment. At the same time, investment strategies have aligned with analyses of long-term fundamentals that enable a more counter-cyclical approach and, where possible, identify investments driven by durable income returns that are dislocated from economic cycles. As a result, the range of real estate investment solutions that meet the current and future requirements of the economy and society expanded significantly.

The two defining characteristics of these investments are that they represent a more operational form of real estate (the occupying business operation being anchored to the real estate asset) and span a wide range of both existing sectors and new economic segments. These include multiple niche segments of the Residential sector, namely; Senior Living, Micro-living and Co-living, as well as Student Accommodation, Healthcare, Data Centres and Hotels. Mirroring the economic sectors underpinning them, these sectors are growing rapidly. However, operational real estate segments are also embedded in the Residential and Mixed Use sector, which together with operational real estate sectors have increased their share of the INREV Annual Fund Index from 17.5% to 32.8% between 2010 and the end 2019. Given the strength of underlying long-term demand drivers and increasing investor appetite for assets that can generate long-term durable income streams, operational real estate's share of the investment universe is expected to increase over the next decade.

This research explores the risk characteristics of the evolving real estate investment sectors that comprise operational real estate in Europe and their implications for the investment approach in terms of objectives, structure, and resource requirements. The research is primarily based on a structured interview approach, with findings derived from the analysis of twenty-two interviews undertaken between June and August 2020 with eight investors, twelve investment managers and two multi-managers (Appendix 1).

Each interview was analysed consistently to understand the range of diverse views. The evaluation of this primary research is supported by existing literature and data.

The operational real estate market offers a wide diversity of risk and return characteristics across sectors, market maturity, and stage of asset development. This research examines the variation in exposure to operational risk across the full spectrum of these segments. It explores how the desired degree of operational risk may be managed by investment structure and considers the scale and expertise implications for managers and investors. It also considers the range of investing options these assets offer to investors across a full risk spectrum, starting from real estate as a product to real estate as a service, and evaluates the potential implications for the wider real estate investment market.

2 INREV Fund Index 2015 to 2020 and Investment Intentions Survey 2020

Section 2

Defining operational real estate investment

Defining operational real estate investment

- All real estate has operational risk exposure, which has been increasing as business life cycle and lease lengths have shortened
- Operational risk exposure is more elevated for operational real estate as the occupying business is anchored to the real estate
- More broadly, real estate is on a trajectory from space delivered as a product to space delivered as a service, but investors can choose their level of participation
- Allocations to operational real estate and residential have expanded at a faster rate in recent years than traditional sectors
- Operational real estate represents a diverse range of market segments that have a large dispersion of risk characteristics, providing investors with different opportunity sets

Operational risk and real estate

Since the turn of the millennium, a combination of factors has gradually edged operational risk upwards, evidenced in reduced timespans of business lifecycles and shortening lease lengths. Moreover, as the real estate landscape adapts to shifts in how we live, work and play there is a greater emphasis on tailoring space offerings to a specific target audience to maintain relevance and effectively manage risk. All assets may be placed along a continuum of operational real estate risk exposure, with the position determined by the certainty of income and its duration. The provision of real estate is still the key to value but, in some circumstances, unlocking it may also require the provision of services either directly or through an intermediary. To some extent, this is true of established sectors as well as more operational forms of real estate.

> 'The provision of real estate is still the key to value but, in some circumstances, unlocking it may also require the provision of services'

Although real estate owners are becoming more active investors across all asset classes, this does not in itself constitute operational real estate. Indeed, although their exposure to operational risk has risen these sectors are considerably greater in scale and maturity to the sectors comprising operational real estate and they benefit from a larger and more diverse occupier base. However, this is not what distinguishes them from operational real estate. There is a clear distinction between risk exposure to a tenant's business as an occupier of an asset, but otherwise unrelated to it, and an operational business service being driven by the occupation of the asset, and directly dependent upon it.

Accurately quantifying the size and scope of the operational real estate sector is challenging for several reasons. First, there is no well-established definition of what constitutes operational real estate. Second,

> 'There is a clear distinction between risk exposure to a tenant's business as an occupier of an asset, but otherwise unrelated to it, and an operational business service being driven by the occupation of the asset, and directly dependent upon it.'

many forms of real estate are on a trajectory that shifts real estate investment from solely being delivery of the physical product to one which sits along a continuum of real estate delivered as a product, to real estate as a service. Therefore, while this research focuses on the most accepted forms of operational real estate, the landscape is gradually extending to new sectors, segments and operational models.

Although there is no accepted definition for operational real estate, it is generally used to describe assets that have an elevated exposure to operational risk. Of course, operational risk has always been embedded in all real estate investments and central to the due diligence involved in underwriting covenant strength. Over the past decade, its prominence has increased as structural change has increased disruption, disintermediation and dislocation of occupiers' business models. However, exposure to operational risk is not binary, rather it varies across sectors and segments and increasing exposure to it does not in itself classify an asset as 'operational real estate'.

Importantly, being categorised as operational real estate does not necessarily indicate that income is directly variable with operational revenues. Although some investments may have at least a proportion of income based on a performance metric, many are characterised by long lease durations and inflation-adjusted rents, while others provide annualised income streams. Indeed, for some investors, the duration and certainty of income offered by some investment opportunities counterbalance the elevated operational risk that stems from income being dependent, directly or indirectly, on the operating business' capacity to generate revenues from the asset.

> 'A determining characteristic of operational real estate is that the asset is integral to the product or service being offered to an end customer and therefore, the income generated within the asset.'

Defining operational real estate

Despite the term 'operational real estate' being frequently used to describe a wide range of real estate assets a definition of what constitutes 'operational real estate' has not been well established. A determining characteristic of operational real estate is that the asset is integral to the product or service being offered to an end customer and therefore, the income generated within the asset. To this end, operational real estate may be defined as the real estate component of real estate anchored businesses. It can be held in separate ownership or integrated with the operational business model, but the operating business and real estate will usually be easily distinguishable as two distinct entities whether in separate, joint or whole ownership (see Section 5).

Box 1. Operational risk in established real estate sectors: retail

Successful shopping centre owners have taken an operational role in their assets for over a decade. Understanding the local audience and the consumer opportunity it offers on behalf of their occupiers, tailoring the retail mix, leisure services, developing marketing activities and events to attract and retain consumers, and analysing its impact on turnover. Rental values reflect an affordability model of turnover less costs, with online retailing lowering in-store sales and increasing the operating costs for retailers in the form of digital channels and distribution.

The use of turnover rents (in addition to base rents) introduced a variable element to income that was previously used to capture growth, with no downside risk. Although directly related to operational performance, turnover rents also provide investors with an important risk metric enabling the performance of the centre, retail categories and individual retailers to be benchmarked. This is arguably at least as important as the capture of growth. A separate service charge is levied for marketing activities and other services, with rents for real estate clearly segmented from payments for services. Although this is a sector in the midst of structural change in how, when and why people shop impacting on lease arrangements, there remain strong retail centres and these are characterised by an operational approach to their management.

The size of the operational real estate sector

Determining the total size of institutional investment in European operational real estate is complicated by several factors. First, in addition to recognised investment categories such as Hotels, Student Accommodation and Healthcare, operational investment also includes segments invested in other more established sectors, especially the Residential sector, as well as Mixed-Use. In addition, there are blurred boundaries between sector and segments, for example between Healthcare and Senior Living, and between Hotels and short-stay accommodation embedded in niche sectors of the Residential and Student Accommodation sectors.

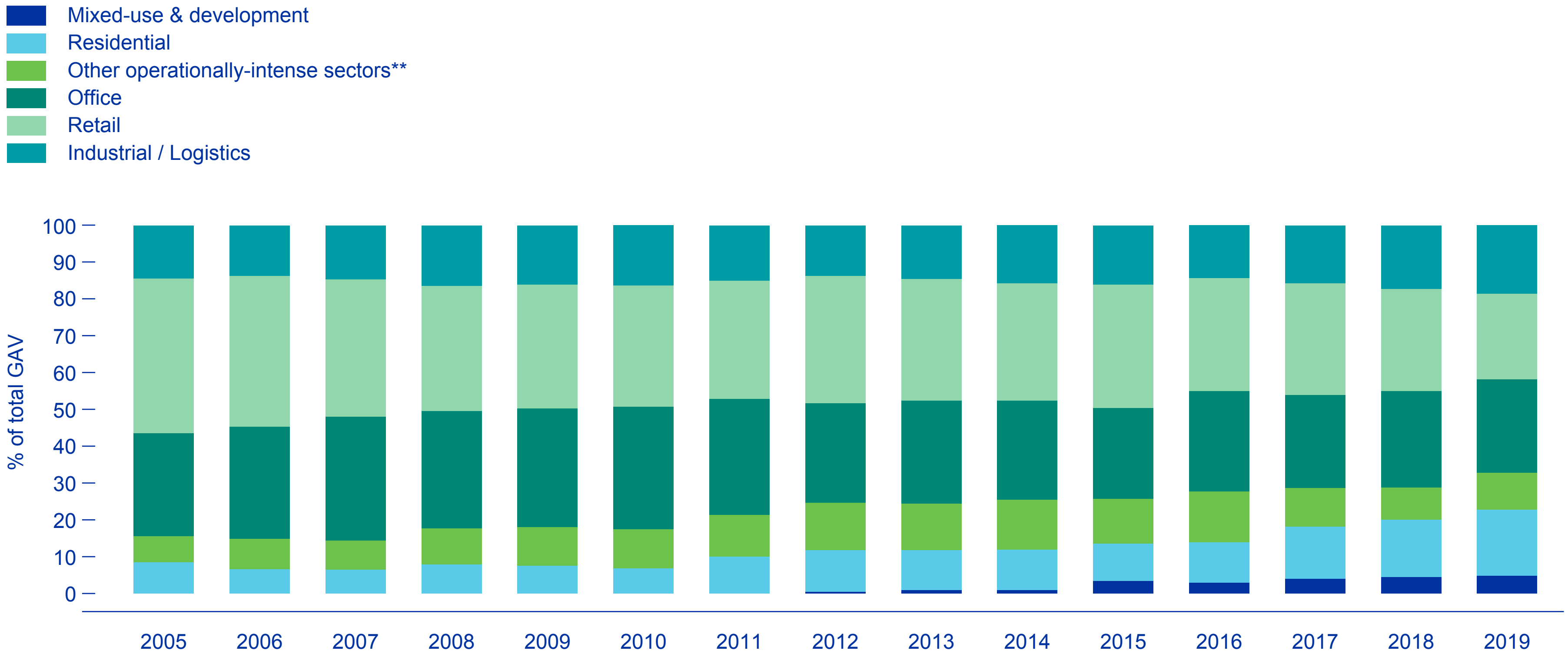
Figure 1. Primary sectors and sub-sectors of operational real estate

Over the past ten years, analysis of the INREV Annual Index indicates that growth in investment allocations in Europe to these stand-alone operational real estate sectors, Residential and Mixed Use has outstripped that of Office, Retail and Industrial/ logistics (Figure 2). Between 2015 and 2020, fund allocations to the European Residential sector almost doubled from 10.2% to 18.0%[3]. Although the sector is dominated by multifamily private rented sector assets (PRS), 25% comprises other assets which include several of more niche operational real estate segments, for example, Co-living and/ or Micro-living, as well as segments of Senior Housing[4].

3 INREV Fund Index 2015 to 2020

4 Savills (2019) Global Living Report

Figure 2: Capital allocation by sectors*



Source: INREV Annual Fund Index 2020

* Excluding cash and unreported figures
** Aged care, health care, hotel, leisure, parking, student housing, other

Box 2. Operational risk in established real estate sectors: logistics

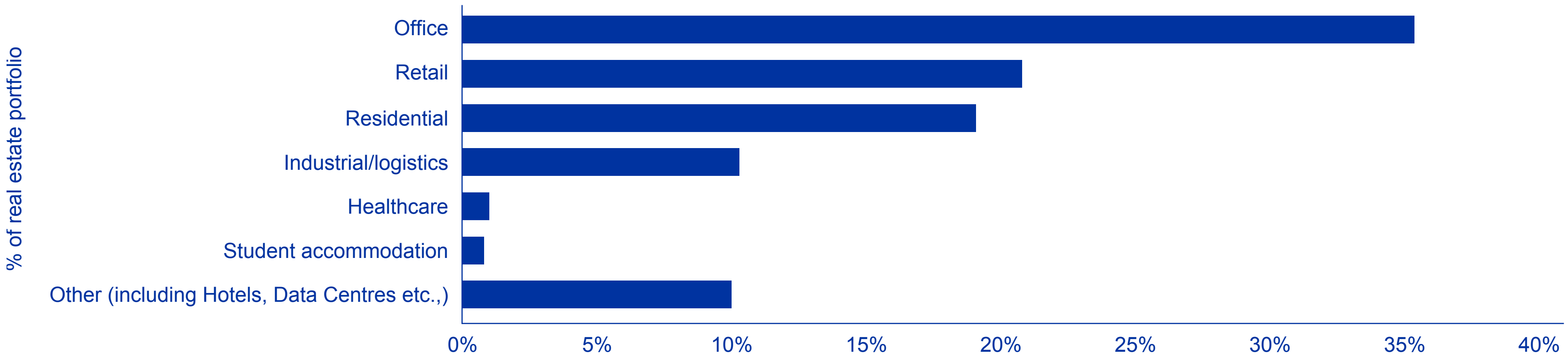
Logistics is also driven by affordability, with logistics operators running on narrow margins. Sector specialist investment platforms understand the operational business models of their occupiers and identify where the risks are in terms of the quality and diversity of their client base and the length of contracts. Equally, they consider the economic sustainability of a location from the perspective of occupying businesses, for example analysing the availability and cost of appropriate local labour. Institutional capital active in this market may also select whether to finance or offer space as a product or to participate in offering space as a service through a joint venture partnership.

This data represents investments made through non-listed funds and does not capture other investor activity. The shift in large investors' preferred mode of investing towards direct and joint venture approaches is particularly pronounced for alternative real estate strategies[5]. INREV's Investment Intentions Survey (2020) indicates that existing allocations to specific operational real estate sectors in Europe stand at 11.8% (Figure 3). This remains a small, yet significant, proportion of investors' total real estate holdings. In fact, actual allocations to operational real estate are estimated to be significantly higher, given the high allocation to Residential which includes niche operational segments. Investment in the operational sectors is anticipated to increase further, with around a fifth of all investors intending to make specific allocations to operational real estate and almost three-quarters increasing allocations to Residential globally.[6]

5 INREV (2019) Coming of Age: the rebirth and renewal of the non-listed real estate industry

6 ANREV / INREV / NCREIF Investment Intentions Survey 2020

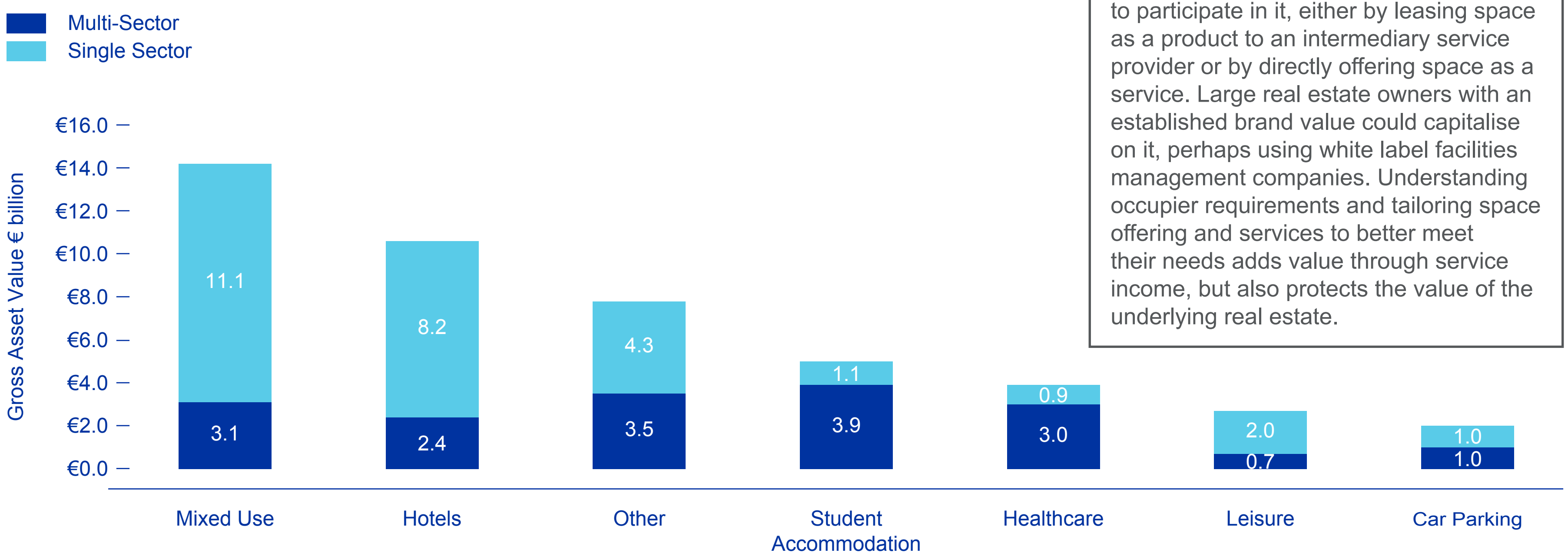
Figure 3: Current sector allocations by investors, year-end 2019



Source: INREV Investment Intentions Survey 2020

Operational real estate is embedded in multi-sector portfolios and, therefore, the opportunity is much larger than is possible to estimate. Allocations may be made to funds with a specific strategy, for example, Healthcare, but form part of a multi-sector portfolio strategy or form part of a broader Residential strategy. Many investors and investment managers have developed strategies that target opportunities across a 'Living' or 'Bed' spectrum that cuts across Residential and Operational Real Estate sectors, including Senior Housing, Student Accommodation, Healthcare and Hotels, in addition to niche segments within the Residential including Micro-living and Co-living. A high proportion of Hotels, Data Centres and Self Storage assets are held by multi-sector funds and while lower, this is also significant for Student Housing and Healthcare assets (Figure 4). Although assets held in multi-sector funds can represent a high proportion of the value operational real estate sectors it is not visible as they often represent a low proportion of their multi-sector fund's value.

Figure 4: Size of operational real estate sectors by funds type (GAV*)



Source: INREV Vehicles Universe Q1 2020

*Gross Asset Value = €46.2 billion

Box 3. Operational risk in established real estate sectors: offices

The operational aspect for offices is less pronounced at the overall sector level. Instead, it is focused on the far end of operational risk exposure and presents the opportunity of operational management and flexibility as has been demonstrated by intermediary facilities management operators, who offer space on flexible terms. The model emphasises the value gap that exists between space as a product and space as a service. Real estate owners are the gatekeepers to this opportunity and can elect how they wish to participate in it, either by leasing space as a product to an intermediary service provider or by directly offering space as a service. Large real estate owners with an established brand value could capitalise on it, perhaps using white label facilities management companies. Understanding occupier requirements and tailoring space offering and services to better meet their needs adds value through service income, but also protects the value of the underlying real estate.

Analysis of the INREV Vehicles Universe indicates that of the € 329.4 billion (GAV) held in funds in Q1 2020, 14.0% represent non-residential operational real estate sectors. Mixed Use and Hotel are the largest sectors, with 4.3% and 3.2% respectively (Figure 5). It is worth noting that this represents allocations through funds and therefore does not include investments held directly by investors either solely or through joint ventures, with several large investors building scale in certain segments.

The operational real estate landscape is diverse

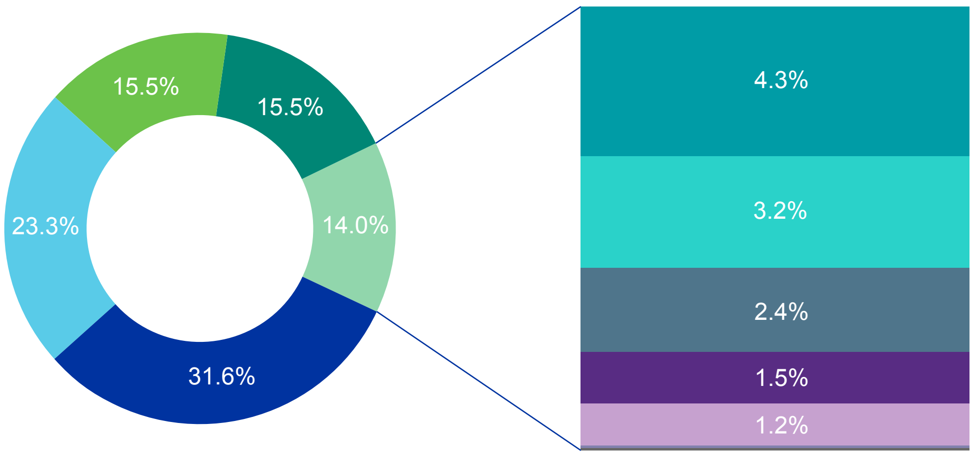
The diversity of the operational real estate is another important factor to consider when forming an understanding of the market size and scope. It comprises a wide range of sectors and their maturity differs across regions and countries (Figure 8). Some operational real estate sectors are well established across and within regions, such as hotels. Others are mature asset classes in some countries, while relatively nascent in others. This reflects cultural differences and variations in the pace of social change. To some extent, it may also reflect whether PRS has always been an established component of institutional real estate investment within individual countries, or if its inclusion as a mainstream sector is the result of more recent activity over the past decade. This variance in market maturity is an aspect of many sectors that essentially lease medium to long-term accommodation and is explained in more detail in Box 4 using the example of the Student Housing sector.

> ‘It comprises a wide range of sectors and their maturity differs across regions and countries’

Figure 5: Operational real estate sectors as proportion by value (% of the total GAV*)

31.6% Office
23.3% Retail
15.5% Industrial / Logistics
15.5% Residential
14.0% Other

4.3% Mixed
3.2% Hotel
2.4% Other
1.5% Student Housing
1.2% Healthcare
0.8% Leisure
0.6% Car Parking



Source: INREV Vehicle Universe Q1 2020

*Gross Asset Value = €329.4 billion

Section 3

Why are investors attracted to the operational real estate sector?

Why are investors attracted to the operational real estate sector?

- Investor appetite has been fuelled by the strength of long-term structural trends benefiting these segments and the durable income streams they offer
- Both sector and market maturity are important drivers in operational real estate decision-making
- Investors are able to tailor opportunities to their differing objectives and mandates from a wide menu of risks and returns
- Investment approaches and risk consideration are driven by how investors perceive the opportunity, which may be categorised into whether they adopt a real asset or a real economy mindset

The interviews reveal that the reasons for investing in the sector are both diverse and multi-faceted. A common element to the basis of all investment strategies is an alignment of strategy with analysis of long-term structural drivers which can be distilled into opportunities within both existing and emerging real estate sectors. This approach enables investors to be more forward-thinking and counter-cyclical in their investment strategies. Rather than responding to change, investors are able to anticipate it and evaluate its likely impact on the demand for, and use of, real estate.

Aligning strategies with long-term underlying mega-trends has enabled investors to identify new opportunities in both existing sectors, (for example, new target markets for hospitality including luxury, business and budget hotels, hostels and camping sites; office hotelling/ flexi workspace; retail place-making; and in expanding opportunities within PRS, including Micro-living and Co-living), as well as other niche sectors (for example, Senior Living, Healthcare, Student Housing and Data Centres).

A key aspect of these opportunities is that they have the potential to generate durable, stable income streams that tend to be somewhat dislocated from economic cycles; within Maslow's hierarchy, the demand for shelter (and many would now argue, wifi) is a basic need. They also offer a premium for their perceived exposure to elevated risk. While the heterogeneity of the risk characteristics between and within these sectors impedes a comparison of their performance, they have consistently outperformed the mainstream real estate sectors since the GFC (Figure 6).

The sectors offer a wide range of risk positions, but new real estate solutions need to be developed to satisfy the underlying – and accelerating - demand. As a result, they have the capacity to attract investors seeking to match diverse investment objectives ranging from long income positions to attractive relative risk-adjusted income returns and/ or those seeking capital growth opportunities. They also provide an opportunity to extend the investment from the supply of real estate product into the service economy. There are two, inter-related, aspects to defining the strategic opportunity, setting the investment scope and selecting the strategic approach.

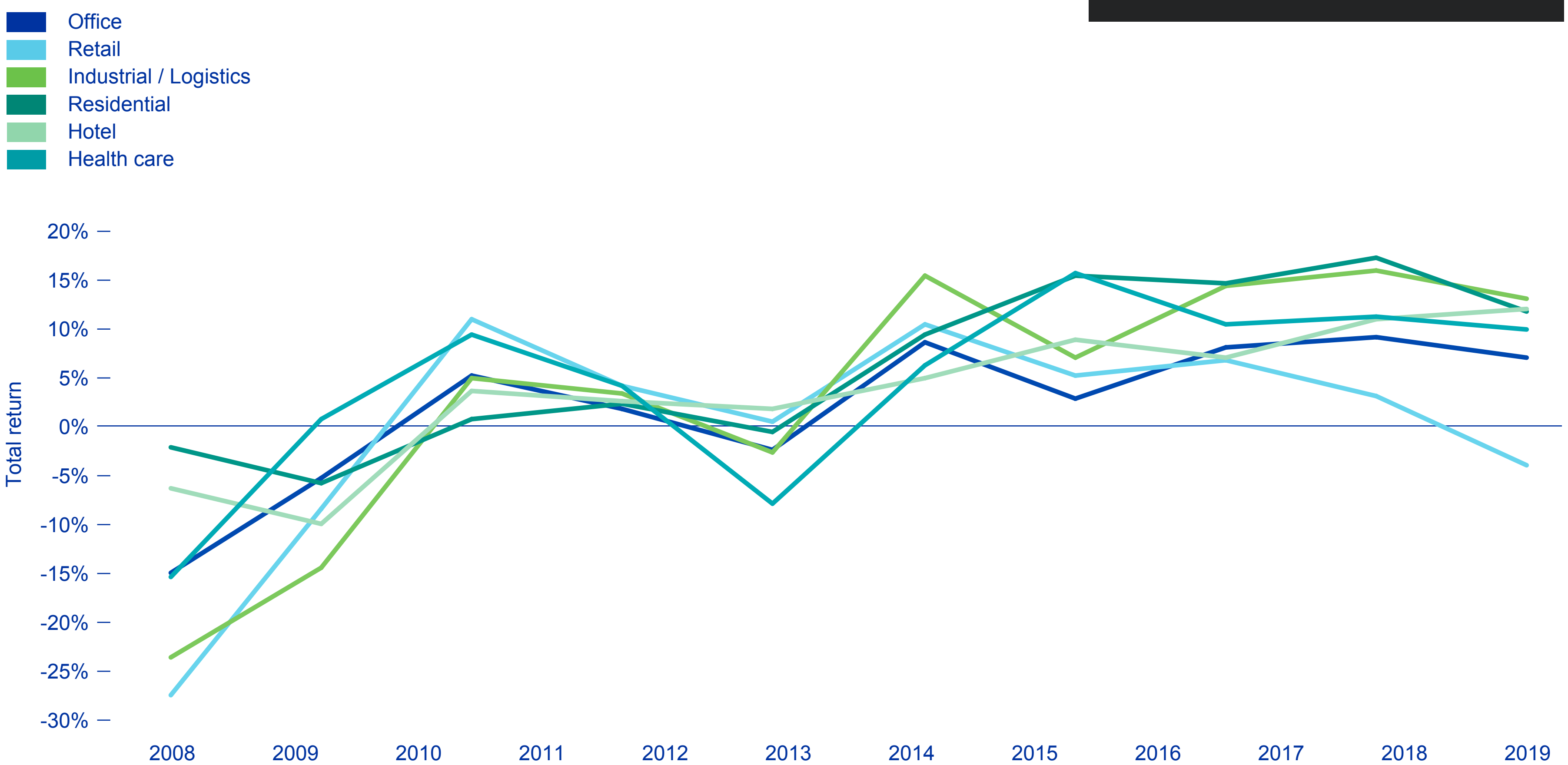
> 'The potential to generate durable, stable income streams that tend to be somewhat dislocated from economic cycles.'

Investment scope

The multi-dimensional risk attributes provide a wide array of opportunities. These differences allow investors and/ or their managers to align their investment objectives to their preferred risk position by selecting and blending risk dimensions (Figure 7). These include at which point to invest in an asset, from concept through to stabilised asset, the risk of which will vary by sector as well as across and within markets at the country, regional, city and micro level. Several interviewees commented that they invest across several risk strategies with the aim of diversifying risk across a portfolio.

> The multi-dimensional risk attributes allow investors and/ or their managers to align their investment objectives to their preferred risk position by selecting and blending risk dimensions.'

Figure 6: Total annual returns single sector funds



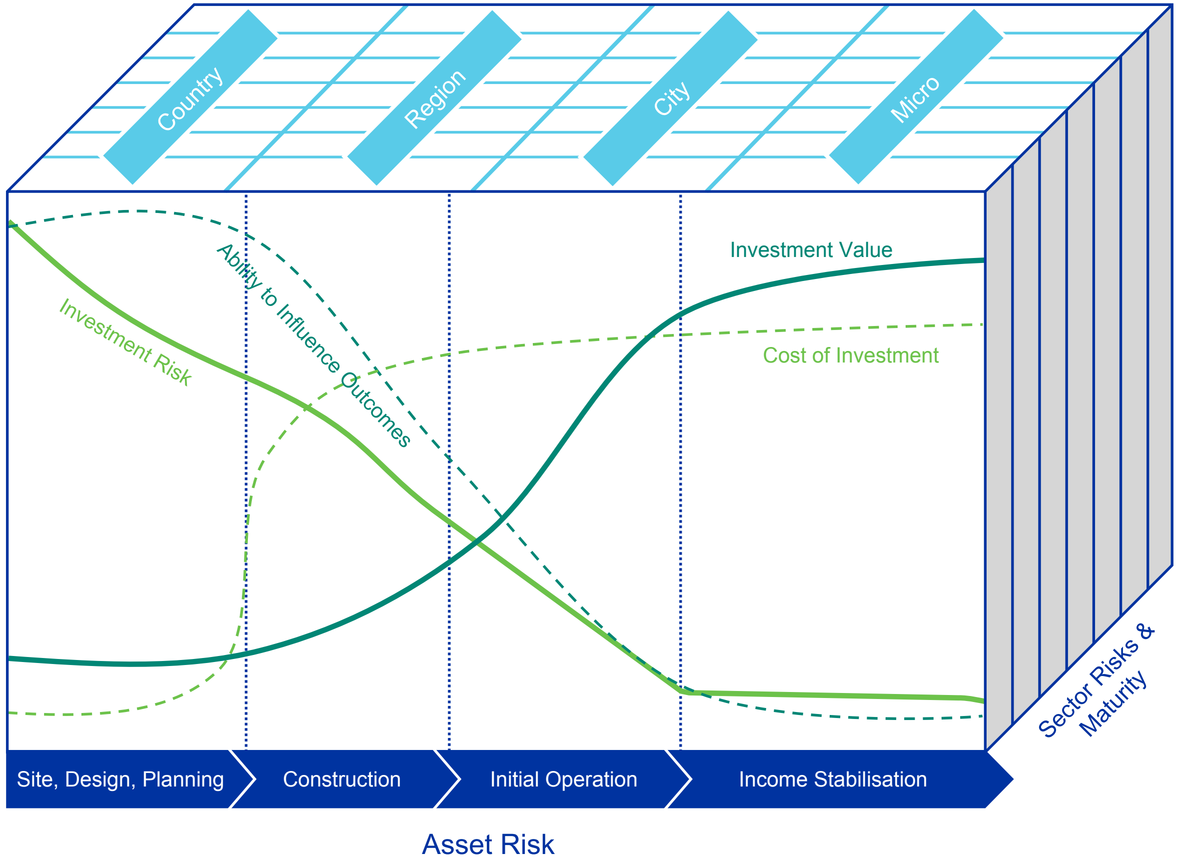
Source: INREV Annual Fund Index 2020

The interviewees explained that it is the number and combination of risk dimensions taken for any single investment that determine investment style, rather than any single specific dimension. For example, core investors are attracted by the stable income returns assets provide at a higher income yield to PRS. As such, core investors focus on standing assets in the most mature sectors and markets that can provide stable and certain income streams.

Long-income investors may also follow this strategy, but they may also take on some degree of development risk, perhaps through a forward sale or they may develop to hold, predominantly in the most mature sectors and/ or the most mature markets. Interviewees pursuing this strategy stressed that develop to hold strategies offered better risk management over the long-term as they provide control over design and the quality of construction, thereby ensuring the durability of the asset over the long-term. It was reasoned that this offered protection against investor-developers seeking to exploit market growth and short-term yield compression in these expanding markets. In addition, they are rewarded with capital growth for an asset they are creating for its long-term, stabilised income profile.

The scale, risk profile and maturity of each sector differ and vary across markets at the country and city level, with specific risk dimensions also varying at the regional and micro-level (Section 4.0).

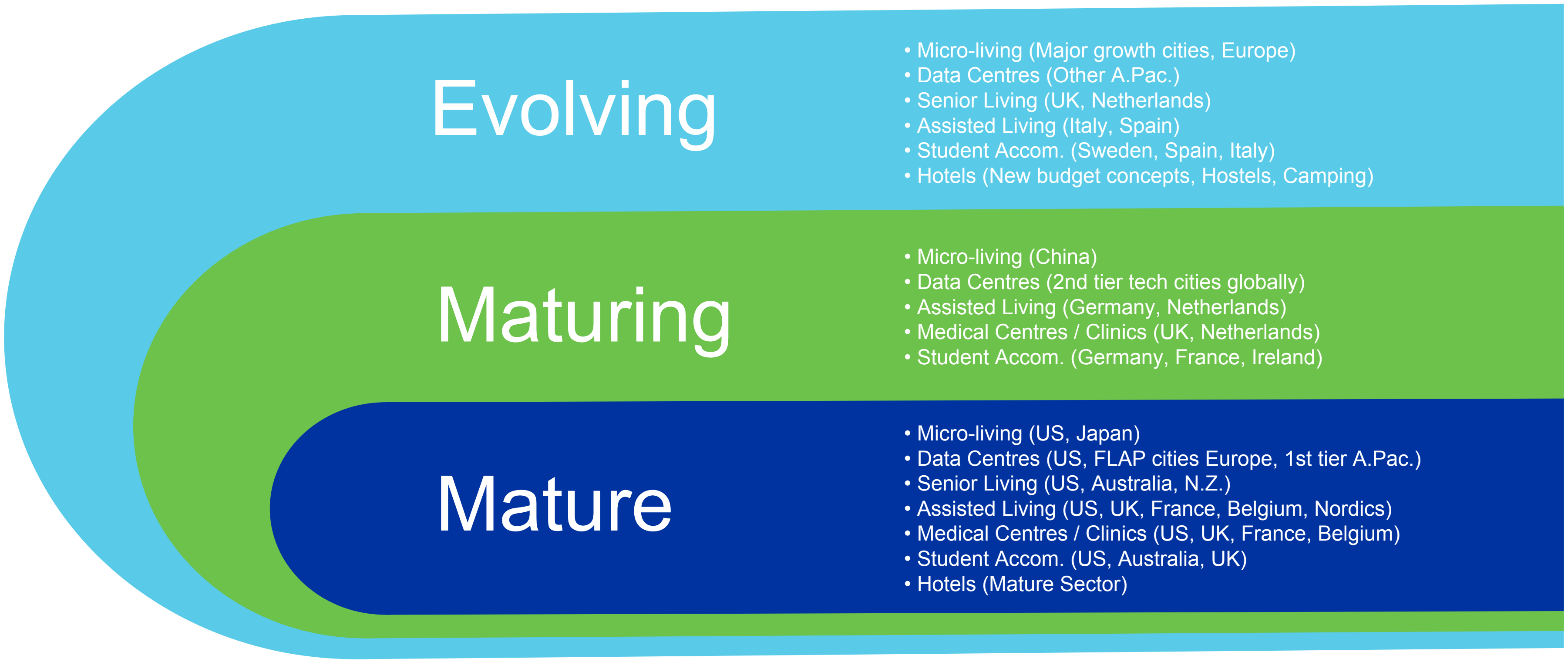
Figure 7: Market Risks & Maturity



Mature markets and sectors
The most established sectors in the most mature markets are characterised by institutional stakeholders, reputable occupiers and/or intermediaries, a transparent regulatory environment and the secondary trading of assets. Such markets provide an opportunity to invest in a stock of standing assets that have a long-run performance history. This attracts investors and managers seeking attractive income returns, with a number of interviewees stating that these niche segments deliver higher risk-adjusted income returns, relative to more conventional residential investments. For example, Nursing/ care homes, Assisted Living and Student Accommodation (particularly on campus) can offer long, stable income flows

> 'Investors seek to be rewarded for the opportunity they are creating and the operational business they are enabling. '

Figure 8: Maturity of Operational Real Estate by Sector



Note: Chart shows indicative maturities as reported in interviews and the range of countries is not intended to be exhaustive.

with established operators in mature markets. There also remains a strong opportunity to develop new assets in these well-established markets due to the strength of underlying demand in these underserved market sectors. This may involve development exposure and/ or lower security of income, with investors compensated by the opportunity to benefit from strong capital growth. For experienced investors and/ or managers in a particular sector with long-standing relationships with trusted operators, this enhanced return may be achieved at a lower perceived risk. Indeed, a number of interviewees commented that as real estate anchored businesses, the real estate remains the biggest proportion of value and therefore of the capital at risk, yet the high returns are in the operating business. A number of interviewees contended that investors should seek to be rewarded for the opportunity they are creating and the operational business they are enabling. Therefore, the understanding of geographic and sector maturity matrix is fundamentally important for operational real estate investment decision-making (Figure 8).

Box 4. Diversity in maturity: Student Accommodation sector

The role of institutional capital in supplying Student Accommodation is long-standing and is a mature segment of the market in the US and Australia. This is a good example of a transfer of knowledge and best practice across markets.

In Europe, the structure of markets and their maturity is more variable. In Germany, studying in a University closer to home is culturally more prevalent and the growth of international students has accelerated more recently with the establishment of English speaking educational programmes. Although this is a maturing market in Germany relative to the U.S., institutional investment activity is evolving quickly, in part because the Residential sector has always been firmly established within the mainstream sectors. The mobility of students in the U.K. and constraints on public funding of Universities attracted investors to the long secure income of on-campus Student Accommodation in the mid-2000s, at a time when the institutional PRS began to expand.

This experience and the higher relative returns achievable relative to PRS amid expanding demand from domestic and international students, has led to the rapid maturity of the PBSA sector over the past decade. In Spain, traditionally most students studied close to home and the structure of the University system resulted in most accommodation being offered and operated by Universities and associated religious orders. However, expansion of third-tier education and accelerating mobility amongst domestic students in their choice of University has resulted in strong demand and a scarcity of suitable product. There are also cultural differences, with a dorm and dining facilities being the norm for design impacting on costs and operational expertise. The market is rapidly evolving, but with few assets reaching stabilised income maturity, institutional investor activity is at an early stage.

Evolving markets and sectors

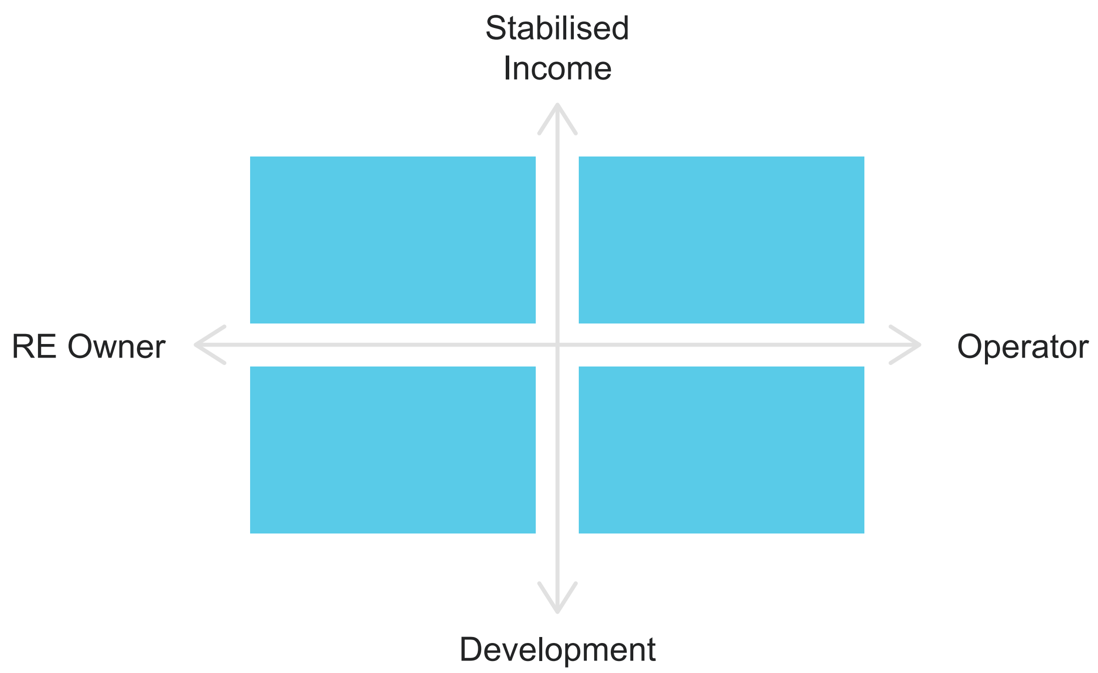
In sharp contrast, the least mature sectors and markets may be underpinned by compelling demand, but may lack an existing body of stock, established investment market, or pool of experienced operators. As such, they represent a higher position on the risk spectrum and offer a higher return. Investors and managers limit the number of risks they are exposed to in any one investment. For example, Co-living and Micro-living are more nascent segments that are responding to the unmet demand for suitable rented accommodation for graduates and young professionals in urban growth centres. The opportunity is primarily undertaken by investors experienced in PBSA who recognise the opportunity to adapt and tailor the concept to a new target audience. As such, it is evolving in markets that already have a well-established PBSA sector, which provides certainty in respect of operational management, familiarity and acceptance of the concept by its future target audience, and importantly, an alternative target audience should the concept fail.

Similarly, investors and managers are creating new concepts for European Senior Living, targeted at Europe's active and wealthy seniors. These offer high spec residential units that are designed to enable affluent, active, independent seniors to age in communities of like-minded seniors. Social and leisure facilities are offered, and a menu of housekeeping and care services can be tailored to individuals as required. The concepts are adapted from mature Senior Living markets in the U.S. and Australia by investors and/ or their managers already experienced in PRS, Assisted Living segments and/or Senior Living in mature markets.

Strategic approach

Besides selecting risk based on investment scope, such as the maturity of the sector, investors and managers participating in the interviews had a wide range of approaches to investment strategy reflecting different risk positions. These positions are interrelated with how they consider the strategic opportunity and the approach required to achieve it. The range of strategic approaches can be broadly categorised into two groups. Those who are seeking to exploit the real asset opportunity embedded in the requirements of new and expanding economies, and those who seek to participate in the growth of the economic sectors, fastened to their real estate and infrastructure requirements. This risk position is managed against the stage of asset maturity, which is a continuum from development to a stabilised asset (Figure 9).

Figure 9: Operational real estate value chain



Real asset mindset
Many investors and managers interviewed are focused on creating and delivering the real estate solutions required by economic growth sectors. Indeed, some investors, notably insurers, are constrained by regulation and many managers are constrained by clear mandates that set parameters for the investment scope in terms of geography, asset and risk exposure. The overriding objective is to derive a return from real estate, clearly separating the real estate and operating business. For some strategies, the emphasis is solely on creating a long-term, secure income stream, and risk-managing through developing a strong and trusted relationship with the operating business. Some strategies will also seek to benefit from the capital growth associated with building a stabilised income. Other investors and managers may also seek to supplement returns from a share in the operating profits, particularly where they are expanding their relationship with an operator across multiple assets and markets.

Real economy mindset

Several investors and managers explained that their strategies represent a more holistic reorientation of their overriding business strategy and organisational structure, effectively transforming their investment mindset. The strategic direction of the business is anchored upon the areas of strongest economic value growth stemming from the analysis of long-term drivers of change. Their access point is to create the real estate and infrastructure solutions that these growth sectors require and through them, ensure they are positioned as stakeholders in the growth of these future economies. In many of the evolving sectors, this investment activity is creating and shaping the built environment and infrastructure for that landscape. Taking a stake in it assists in protecting long-term value in terms of the quality of the asset and the quality of the opportunity itself. These interviewees stressed that this strategic realignment also involves reconsidering the value chain and, where appropriate, reintegrating real estate and operational investments to ensure that they participate in the long-term value being generated, rather than merely facilitating it. The structure of the portfolio is also reinvented, comprising a balanced portfolio of real estate or infrastructure anchored businesses, rather than solely assets.

> ‘Investors’ access point is to create the real estate and infrastructure solutions that these growth sectors require and through them, ensure they are positioned as stakeholders in the growth of these future economies.’

For example, the exponential rise of connectivity and cloud- based technologies presents an opportunity to not merely facilitate the rollout of fibre, energy and technological infrastructure required through developing and leasing data centres, but to own the infrastructure required to drive the new economy. However, the approach demands organisational scale and/ or the ability to draw on specialist expertise from other divisions within the organisation, or the capacity to acquire it. Organisational structure is also a pre-requisite to this approach, with investment allocations based upon a risk matrix approach that removes or blurs the boundaries between asset class silos (private debt, real estate, private equity and infrastructure), refocusing on risk attributes[7].

Although this is a private equity approach, interviewees emphasised that the underlying investment objectives differ from those traditionally common to private equity real estate funds in Europe, particularly in respect of investment duration and the profile of returns. The overriding investment aim is to generate a long-term, stable income stream to benefit from the capital growth generated through achieving it, to create the capacity to grow scale and through full participation have ownership of the new sectors that will drive the economies over multiple decades. In addition, they also offer access to operational income. While a small proportion of overall revenues, it delivers a high marginal return on capital employed and as a consequence has a disproportionate impact on net income.

> ‘While a small proportion of overall revenues, operational income delivers a high marginal return on capital employed and as a consequence has a disproportionate impact on net income.’

Success is ultimately dependent on meeting and exceeding customers’ needs and failure to achieve this impacts on all revenue streams. A fundamental objective of pursuing this approach is to enable direct access to the customer and thereby actively risk-manage the investment through effective customer relationship management. However, this has significant implications for resource and its financial viability requires scale (Section 7.0).

7 INREV (2019) Coming of age: the rebirth and renewal of the non-listed real estate industry

Section 4

Risk attributes of operational real estate

Risk attributes of operational real estate

- Return drivers and risk characteristics of operational real estate vary by sector, including long income, strong relative risk adjusted returns and / or capital growth
- Operational real estate can be a good portfolio diversifier, enabling investors to balance risk exposure within a sector and more widely
- Variation in the risk profiles of different sectors and the diversity across countries in terms of maturity, regulation and cultural considerations are important to consider
- Exposure to operational risk is driven along two dimensions; substitutability of the operating business and alternative use potential – both more pertinent for operational real estate assets throughout the duration of the investment
- Even when the operating model is straightforward, understanding the value drivers of the rental affordability model is more complex and vary across sectors.

Real estate investment profile

For the purposes of this research, investments are segmented into three groups according to their real estate investment risk profiles as detailed by the interviewees (Figure 10).

First, 'Long and secure Bond' representing investments that are generally characterised by secure, inflation-linked leases of a duration of over twenty to twenty-five years in the most mature markets for that sector.

Second, 'Strong Income and Growth', encapsulating assets that benefit from annualised income security, experience and expected annual occupancy churn in more established markets and/ or long-term secure income in more embryonic markets.

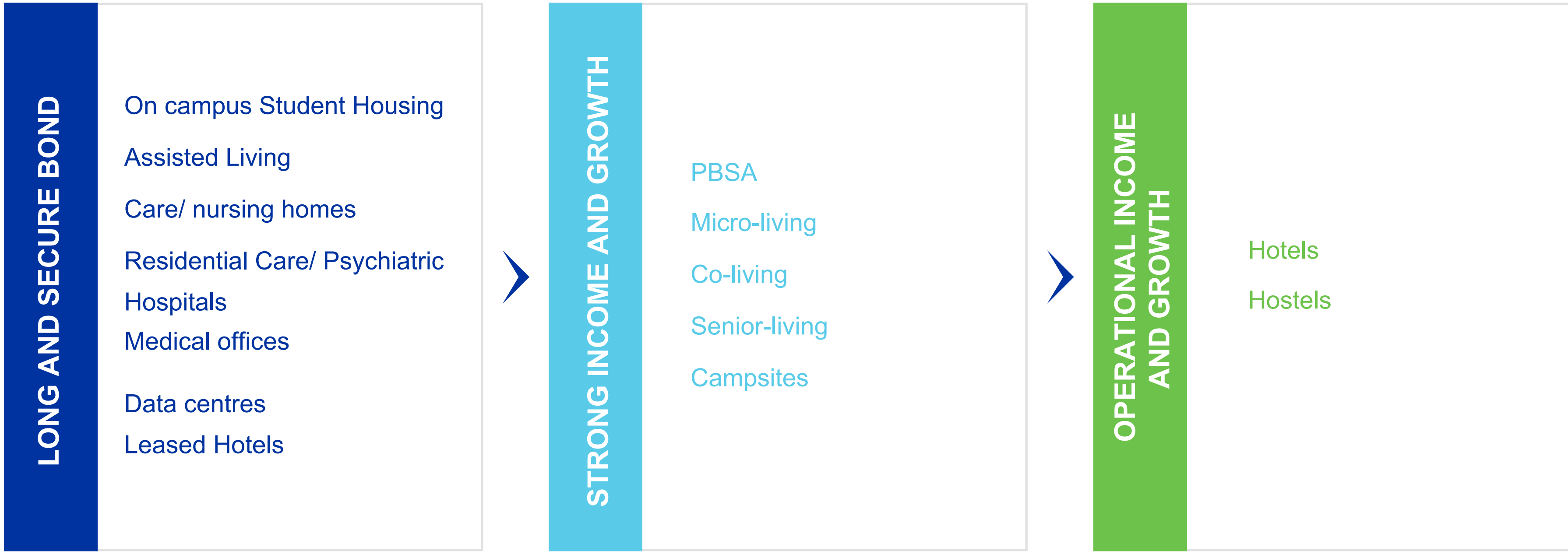
Thirdly, 'Operational Income and Growth', representing investments that are characterised by short-term occupancy and may also have a high proportion of income generated from customer services (for example food and beverage), and/or annualised income in an embryonic market.

Within each risk profile category, there is a wide divergence of risk attributes that render it difficult to meaningfully assess market performance in terms of income yield and/ or returns. In addition to differences between segments, there are wide variations by country in terms of maturity as well as variance in cultural, legal and regulatory considerations in these more regulated markets. There are also blurred boundaries between sectors, as explained in Box 5.

Investment risk and market maturity
Many of the sectors can span the risk spectrum depending on their sub-sector characteristics and the degree of risk also varies with market maturity. For example, on-campus student housing investments are usually structured either as a sale and leaseback agreement or forward sale and leaseback to the incumbent university on a long-term income secure lease. PBSA is usually off-campus, often in central locations and, although university accommodation offices may option the space, the income is less secure. The investment risk will be lower in the most mature Student Housing markets (USA, Australia, UK) and higher in the more emergent markets (Italy, Spain) where the market and investment model is less established and operators are also more emergent.

'It is critical that investors and any operating partner have a full understanding of cultural, legal and regulatory differences, including building specifications. These can vary at the national, regional and local authority level.'

Figure 10: Segmentation of operational real estate sectors by risk profile



Understanding market risk

The interviewees commented that as the majority of operational real estate sectors have a strong customer focus, they are often subject to market regulation. It is therefore critical that investors and any operating partner have a full understanding of cultural, legal and regulatory differences, including building specifications. These can vary between and within countries at the national, regional and local authority level. The interviewees suggested that although taking experience and best practice across markets is an important facet of these markets, operations cannot be simply imported from one market to another. As for all real estate, such opportunities also must be placed in the context of their micro-environment, including an analysis of demand, supply, competitive environment, law and regulation. For example, the Hotel Sector is the most mature market within and across countries, but opportunities are driven by the demand, supply and competitive landscape at the city and micro-level and this will vary by the targeted consumer segment, for example luxury, business or budget.

This is mirrored in student housing markets, with the saturation rates of supply relative to demand varying across cities and differing across market segments, for example between international and domestic student segments. Risk also varies with the size of the total student market and the number and quality of educational establishments. The maturity and structure of the senior care home market vary considerably by country, with differences in social care payment rates, availability and cost of staff at the regional and micro level within mature markets being an important driver of investment viability. This is also similar for assisted living. Moreover, regulations vary between countries in terms of building specifications, density of homes in

Box 5. Characteristics by sector

The operational real estate sector comprises a wide spectrum of assets that vary in terms of the macro trends underpinning them, their maturity as both an operating business and as an institutional real estate investment asset and in the real estate risk attributes they offer. The risk profile of sectors also varies across markets, relatively and absolutely. Figure 1 illustrates the primary sectors and sub-sectors and highlights the blurred boundaries between them. For example, Nursing/ care homes may be considered within the Senior Housing sector, with the real estate opportunity sharing the same macro trend of 'Ageing Society' as Senior Living and Assisted Living. However, the solution it offers to this demographic is focused on the dependent elderly segment requiring wrap around care (intra-mural). The specialist skills required to operate the business means that it shares a blurred boundary with the Healthcare sector. Although some investment strategies focusing on Senior Living do include Nursing/ care homes, the majority of the interviewees considered intra-mural care homes as Healthcare assets.

Similarly, there is a blurred boundary between Hotels, Hostels, Purpose Built Student Accommodation (PBSA), Micro-living and Co-living. Budget hotels tend to be characterised by minimal additional catering or leisure services and Rev/Par (revenue per available room) is strongly weighted towards the room occupancy/ rate. A proportion of some PBSA and Micro-living/ Co-living assets is also, in some investment assets and/or for certain periods, targeted at the short-stay market, with available services comparable to those of budget hotels. Co-living solutions have also been designed to cater to the active senior and share a blurred boundary with the Senior Living segment of the market.

regard to total number of residents, facilities and space per resident etc. while Senior Living is focused on the volume and value of more affluent seniors.

The viability Care/ nursing Homes and Assisted Living is dependent on occupancy, the payment rate per resident, the certainty of payment and the costs of operating the home, including qualified nursing and care staff, catering, energy and equipment. The risk associated with financial sustainability is lowest in France, Germany and the Nordics where social funding for senior care is well resourced through public funding, and the operational sector is well established, consolidating and expanding. However, where public tenders are used to select operators, particularly in the Nordics, detailed analysis to ensure competitive pricing has not undermined business viability is essential. In these sectors, investment opportunities are often secured through forward sales of new developments and strategic alignments between investors and operators. The activity of real estate investors is assisting the expansion of operators into new markets as they are unconstrained by the capital requirements for new premises and in addition, their strategic partner shares a long-term horizon. Structural change is leading to new opportunities in the underserved markets of Spain and Italy. These opportunities again require a higher return to compensate for the risk of developing an unproven real estate solution in these markets and, in addition, the greater reliance on private-pay clients, with relatively low levels of social care funding.

Balancing portfolio risk

Long income and core investors seeking a lower, but secure income return focus on either 'Long and Secure Bond' or 'Annual Churn' investments. Investors seeking to invest in long-term opportunities with strong income and capital growth opportunities commented that they balance their portfolios between secure and less certain income streams. For example, on-campus Student Accommodation provides a core style, long stable income which balances investments in annualised income streams from PBSA, which compensate with a higher return. Similarly, some investors seek to limit exposure to development or to assets that have not reached income stabilisation to between 20% and 35% of a portfolio, particularly when investing through non- listed vehicles.

Blending income risk at the asset level
Equally some investors and managers seek to build a blended income risk profile within a specific asset, particularly in regard to Co-living, Micro-living and PBSA where a proportion of the asset can be let on an annual lease with an expectation of a high renewal rate, a proportion on shorter one to six-month terms and a proportion on short-term and periodic stays, with the rental rate reflecting the desired flexibility. In this sense, it mirrors approaches used for certain assets in the office sector and the approach being used by intermediaries seeking to operate their occupational portfolios as a space-service, rather than a product, such as WeWork.

Operational Experience has a price
Risk and return profiles also vary with investment structure and with the scale and experience of an operating partner. For example, investors and managers active in Student Housing commented that appointing an operator with an established brand and scale reduces risk and management intensity, but comes at a financial cost either in terms of a higher management fee, higher performance fee and/ or lower share of net operating income (Section 6).

Operational risk

Although direct exposure to operational risk varies with investment structure (section 5), all investments are subject to varying degrees of operational risk indirectly. The smaller scale of these investment sectors, coupled with the importance of local market attributes makes it difficult for investors to rely on comparative market analysis as a means of determining value. Rather, it is essential that they understand the operational risk of the asset and the affordability model underpinning the revenues, costs and profit of the operational business. To some extent this is true of all real estate, with detailed due diligence required on the financial strength of potential lessees prior to finalising a contract. However, for operational real estate this interrogation of business models, financial performance, supplier and customer relationships is ongoing throughout the duration of any lease or management contract.

Operational risk dimensions
From a real estate perspective, exposure to operational risk is driven along two dimensions; substitutability of the operating business and alternative use potential (Figure 11). All real estate sectors have some degree of exposure to operational risk. Prior to agreeing to a lease, due diligence will be undertaken on the financial strength of the potential occupier. For operational real estate, this analysis of operational performance continues throughout the lease.

The substitutability of the occupier is the major difference between mainstream and operational real estate sectors in respect of operational risk. In prime office markets, the failure of a business occupier will cause a break to income, but there is an occupier market across a diverse pool of industries from which to source a substitute occupier.

> ‘From a real estate perspective, exposure to operational risk is driven along two dimensions; substitutability of the operating business and alternative use potential.’

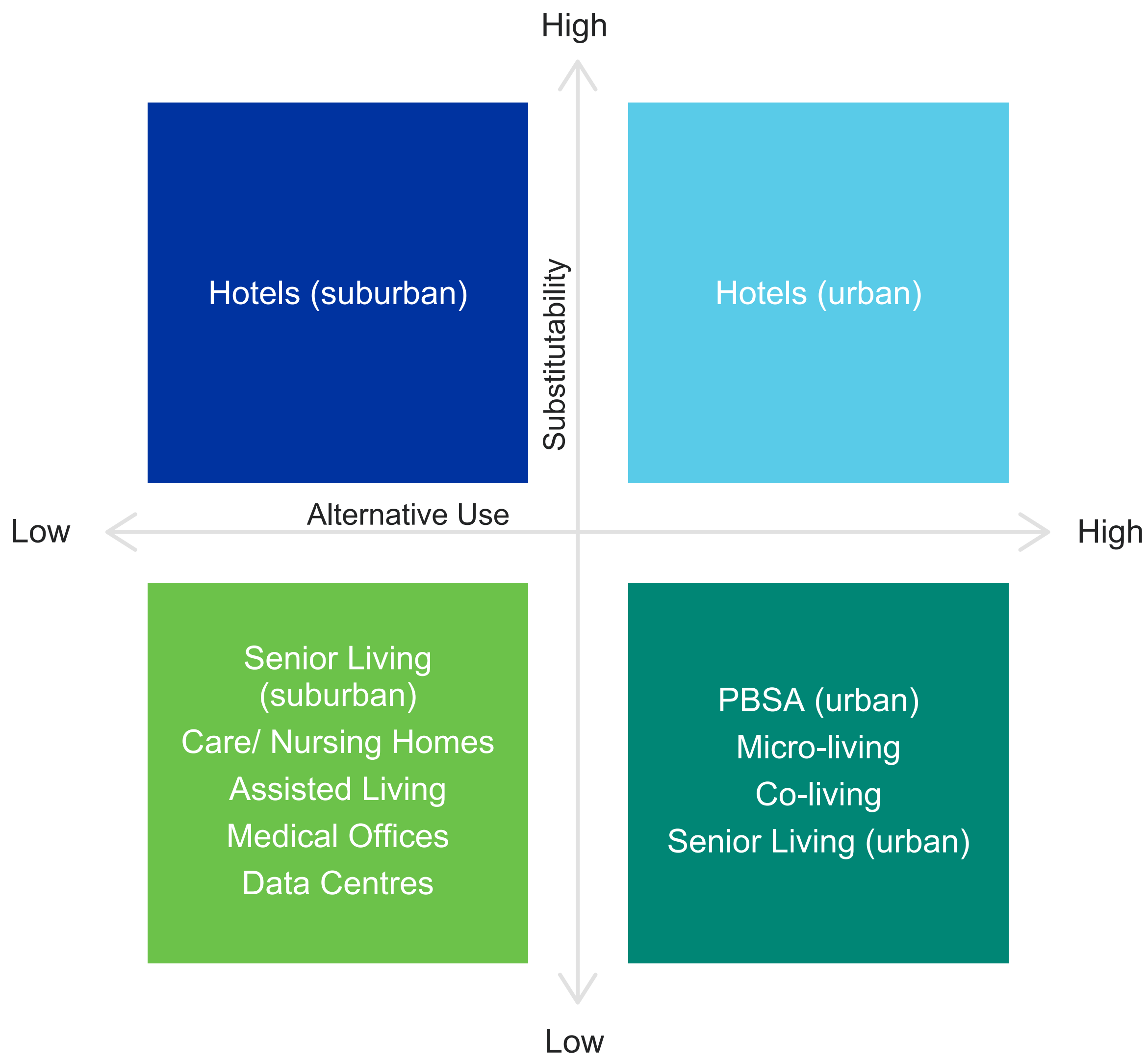
Within the operational real estate sector, the pool of substitute occupiers is smaller and from within the same industry. Unless an operating company fails due to specific business structuring issues, their failure likely indicates an issue with the ability to generate sufficient revenue from the asset. The larger and more diverse the potential pool of occupiers the lower the risk (Figure 11). For example, a city centre hotel provides a wider pool of potential occupiers across multiple segments in comparison to a suburban assisted living or Nursing/ care home.

Several interviewees indicated that student housing, micro-living, senior living, co-living, PRS, residential, budget hotels and hostels share common attributes. Recognising that regulation differs across the sectors, investors are seeking to reduce their exposure to operational risk by incorporating flexibility in use into building designs, thereby increasing substitutability. Location of the asset is an important dimension. On-campus or non-centrally located student housing or hotels have low alternative use potential and therefore higher operational risk exposure. This is reflected in lease arrangements, with long, inflation adjusted fixed income leases being common to assets that have low occupier substitutability and low agility in respect of alternative use.

Operational business model
Institutional investors recognise that there is a greater need to consider the operational business underlying real estate investments in operational real estate sectors, regardless of whether the risk exposure is direct or indirect. As explained above, investments offering very long, index-linked leases may offer a more certain and clean return on real estate in contrast to investments directly linked to revenue, but also tend to be more dependent on the success of the underlying operational business specific entity and/ or to the sub-sector itself. All investors and managers stressed the importance of understanding and monitoring the operational business model to mitigate risk.

Interviewees considered the operational real estate sectors to have relatively simple business models, at least conceptually. Like Hotels, Student Housing and most forms of Senior Living, Co-living and Micro-living, income risk, as well as potential growth, can be measured by monitoring rental affordability with rent either considered as a percentage of revenue or operating profits. Operating profits are based on a form of RevPar less total costs. Although real estate revenues are a high proportion of capital at risk and income, the marginal return on services is

Figure 11: Operational risk dimensions by sector



high and has a disproportionate impact on net revenues. This is most complex for full-service hotels where additional food, beverage, event and leisure service may contribute a high proportion of total revenues. Revenues for Budget Hotels, Hostels, Student Housing, most forms of Senior Living and Residential Social and Healthcare, Co-living and Micro-living are largely driven by the average room rate x occupancy rate, with Hotels characterised by a more variable cashflow than other sectors such as Student Housing, where rooms are usually leased/ licensed for 48 weeks.

Income Metrics
Although the operating model is straightforward, understanding the value drivers of the rental affordability model are more complex and vary across sectors (Section 6.0). For example, Nursing/ care homes, Assisted Living and other forms of Residential Social and Healthcare facilities often operate on narrow margins and may be underpinned by social care payments and/ or private pay residents. These assets are usually let on long leases and the rent uses affordability measures that are more akin to those used for debt, reflecting the bond-like structure of the income. Interviewees active in this sector detailed that rents are usually set using a multiple of EBITDA to rent ratio, with care to leave headroom in the operator's margin on revenues given the sensitivity of their business models to small changes in the cost base. The rate of social care payments varies by regional and/ or local authority across most countries. The costs associated with delivering care also vary, with the cost – and availability - of staff being a key driver of profitability. Equally, small changes in other costs such as catering, energy or changes in regulations impacting on density, staff ratios or service delivery can have a disproportionate impact on profitability.

'Understanding the value drivers of the rental affordability model are complex and vary across sectors.'

The Senior Living segment follows a similar business model where the investment strategy is to develop and lease. In essence they are a part of the PRS, narrowly focused on their target market in terms of age appropriate design, amenities and available services, including a menu of housekeeping, health and social care services are offered to enable occupiers to age in situ. Amenities include food and beverage, leisure and communal spaces. These provide an income stream, but their primary role is to build a sense of community and social opportunity focused on a target audience of like-minded active seniors which drives investment value.

Many investment strategies employed by interviewees in this segment are based on the sale of units upon completion to occupiers and underlying business models vary from the RevPAR affordability model. Investments are managed through monthly/ annual service charge levies and an income flow is generated from amenities and a menu of services. However, the return is primarily generated from the initial sale of assets and the generation of a cashflow from event fees due upon the sale of the asset, ranging between 10% to 20% of the sale price depending on the duration the asset was held and the apportionment of risk, for example whether the owner of the unit or investor takes responsibility for finding a purchaser. By scaling portfolios, a steady and predictable cashflow can be generated over a medium-term horizon as the investment matures.

'Although real estate revenues are a high proportion of capital at risk and income, the marginal return on services is high and has a disproportionate impact on net revenues.'

Data Centres also differ, with interviewees active in this sector emphasising the potential for the operator's capacity to derive revenues being dependent on the energy and fibre connectivity of the asset. Indeed, some interviewees explained that rents are related to the capacity of kilowatts of electricity rather than per unit of space (see Box 6). Although other interviewees active in this sector used square metres as the rental base unit they stated that the value was driven by the electricity capacity.

In addition to real estate rent, most sectors, with perhaps the exception of Care/ nursing homes offer the opportunity to benefit from additional income streams from business/ consumer service offerings directly related to the real estate space offering. Excepting full-service Hotels, this income is a small proportion of total income and services are often outsourced in a management contract. However, the service offering may be fundamental to the demand/ rental level of the asset and net revenues have a disproportionate impact on returns as they are not subject to further deductions. Managing this risk and the potential return has implications for investment mode, investment structure and/ or required asset management expertise.

Box 6. Data Centres

Data Centres sit on the blurred boundary between Utility Infrastructure and Real Estate, with some investors making allocations from infrastructure, some from within real estate, with those adopting a risk matrix approach allocate towards its long-term, secure income profile. This blurring is also evident in its income metrics. Although Data Centres require specific building design criteria to have functionality, their dependence on access to energy and fibre networks is central to the viability of their business. Rents set on a unit area of space are indirectly related to energy capacity as this determines the potential volume of data. Some investors instead lease per unit of energy capacity, essentially directly relating the rental income to the volume of data leased, or potentially leased, by the operator. This also safeguards against change in technology that has the potential to reduce the required occupied space, but not the energy usage, potentially reducing income without any corresponding reduction in business volume. Indeed, it is not unforeseeable that technology changes could reduce space required and at the same time, enable an increase in the volume of data per unit of energy. For long income investors seeking a certain, inflation hedged return it may be of little concern. For investors seeking to participate in this fast-growing sector, having a rental metric that enables them to benefit from business volume growth is attractive.

Section 5

Investment structure and operational real estate

Investment structure and operational real estate

- The effective management of alternative real estate requires specialist operational knowledge and expertise which may be resourced by the platform or achieved through acquiring the services of a specialist operator
- There are four principal frameworks employed to structure alternative real estate investments, namely ‘Leasehold’, ‘Management Contract’, ‘Shared Interest’ and ‘Hold Co’
- The ‘Leasehold’ structure involves a clear distinction between the real estate investment and the operating business, with the asset usually let on a long lease of twenty to twenty-five years
- ‘Separate Entities’ involves a joint venture between a real estate owner and an operating company, with the operating company granted a management contract in respect of the asset
- ‘Shared Interest’ models are a joint venture arrangement which continue to have two separate entities in respect of an OpCo/PropCo structure. However, in this model, the real estate owner also has an interest in the OpCo
- In the ‘Hold Co’ model, the joint venture partners own the OpCo and PropCo. To some degree this represents a reintegration of real estate with the business, which varies with the specific arrangements of the structure

The next important step in evaluating the complexity of operational real estate investing is the use of investment structures to mitigate risk and explore opportunities. Investment structures are a determining factor as to whether an investment in operational real estate constitutes an investment in an operational business, or whether it is a real estate investment characterised by increased operational risk exposure. The effective management of operational real estate requires specialist operational knowledge and expertise which may be resourced by the platform or achieved through acquiring the services of a specialist operator. The relationship with the specialist operator is central to investment structure and reflects the investment objectives, risk appetite and approaches to risk management undertaken across the sample of interviewees.

Broadly, the range of investment structures mirrors those commonly applied to Hotel investments in terms of the separation of the OpCo/ PropCo structure. Figure 12 shows the four principal frameworks employed to structure investments, namely ‘Leasehold’, ‘Management Contract’, ‘Shared Interest’ and ‘Hold Co’.

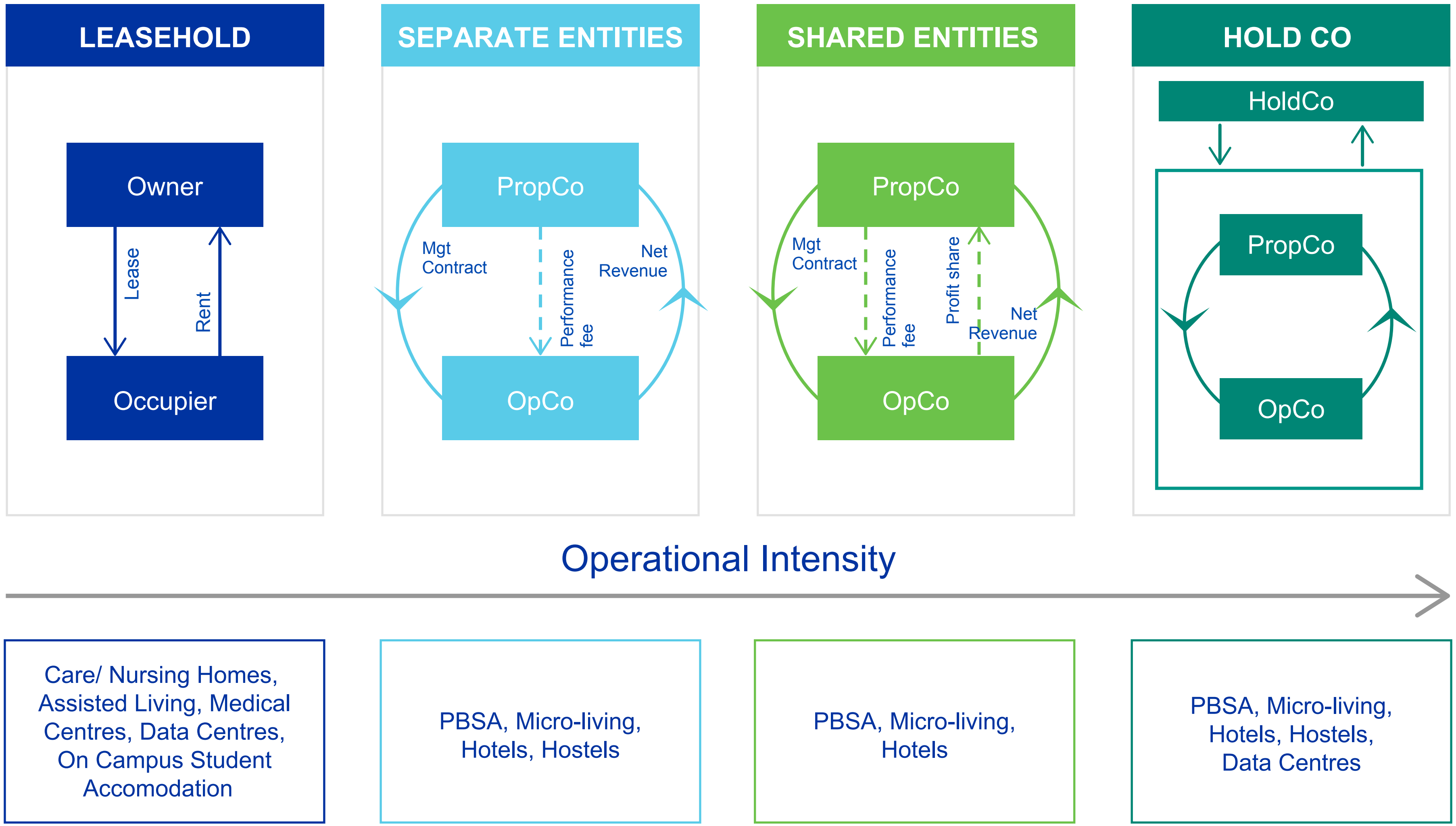
Leasehold model

The ‘Leasehold’ structure involves a clear distinction between the real estate investment and the operating business, with the asset usually let on a long lease of twenty to twenty-five years. Amongst the interviewees, this was most commonly used for Nursing/ Senior Care, Assisted Living and on-campus Student Accommodation and is one of the options employed to structure off-campus PBSA,

> ‘The ‘Leasehold’ structure involves a clear distinction between the real estate investment and the operating business, with the asset usually let on a long lease of twenty to twenty five years.’

Hotels and Data Centres. There is no joint venture arrangement in respect of operational profits, but particularly in respect of Senior Living segments and PBSA, there is usually a formal relationship between the real estate owner and occupier, including requirements to report on key performance indicators and to communicate any issues that arise at an early opportunity. Investors and managers also

Figure 12: Investment structures employed



secure rights to terminate the lease and replace the operator should certain performance, operational or regulatory criteria be breached.

Separate Entities

'Separate Entities' involves a joint venture between a real estate owner and an operating company, with the operating company granted a management contract in respect of the asset. This arrangement is summarised by the interviewees as including a management fee paid to the OpCo for taking the responsibility of generating the revenue, with a first return paid to the PropCo, essentially a base rental income aligned to either a return on capital invested similar to debt, or the rental value of the asset based on a rent ratio affordability model of expected turnover less costs. The OpCo can receive a performance fee for revenues beyond the initial predetermined real estate return. These revenues are split on a 90/10 basis between the PropCo and OpCo, although the proportions may vary according to the scale and experience of the operator. This model is attractive to investors seeking long-term secure income and who seek clear delineation between real estate and operational risk. A variation on this model is where the investor or investment manager also owns the OpCo.

'Separate Entities' involves a joint venture between a real estate owner and an operating company, with the operating company granted a management contract in respect of the asset.'

Shared Interest

'Shared Interest' models are a joint venture arrangement which continues to have two separate entities in respect of an OpCo/PropCo structure. However, in this model, the real estate owner also has an interest in the OpCo. Such arrangements usually involve the strategic alignment of an investor and operator, with the investor's capital assisting the operating company to grow scale through funding the development and/or acquisition of assets. As the portfolio grows, some investors are eager to achieve a return on the brand value they are assisting in establishing. Interviewees commented that this a feature of PBSA and niche Hotel investments, which are characterised by negative cashflow in the initial years until reaching a breakeven point. To avoid downside risk, the interviewees commented that their exposure to the operating company is usually structured as an option to participate at a future point. 'Shared Interest' models can also be employed in the structure of individual investments, but the motivation is usually skewed towards having greater visibility of the operating model and

'Shared Interest' models are a joint venture arrangement with two separate entities in respect of an OpCo/PropCo structure. However, in this model, the real estate owner also has an interest in the OpCo.'

being able to bring insights of best practice from the activity on other investments and markets. Depending on the scale and experience of the operator, the operator may also seek a stake in the PropCo, beyond the usual performance fee arrangement.

Difficulties with 'Shared Interest' models can arise upon disposal as the real estate investor and the operator may have differing views as to how value is attributed between the asset and the operating company. Hotels and Student Housing usually have a higher value when offered with vacant possession as it widens the potential market to owner-operators, or to investors who perhaps have a strategic alignment with another operator. However, reducing the scale of the managed portfolio also impacts the value of the operating company.

This is also complicated for PBSA as the role and value of operating brands evolve as individual markets mature, as does the balance of shared ownership. In this sector, many such arrangements evolve in the early stage of the market where the only opportunity to access product is to develop it. Operators are relatively nascent at this stage and there is an opportunity for both companies to grow scale through a strategic alignment. The PBSA market evolved in the post GFC era as private equity groups including Carlyle, Blackstone and Oaktree repurposed distressed assets into student accommodation. Although operating businesses were developed to manage the assets they were not considered to have innate value and were, in essence, given for gratis with the disposal of the mature, stabilised portfolios in 2015 and 2016. In 2020, one of the same private equity groups purchased IQ, a branded student housing company, at a yield just under 4%. Although the interviewees concur that the value of operational assets is strongly anchored to the real estate assets, the expertise of operating companies is also of value.

In evolving markets with nascent operators, Shared Interest models will reward operators with a small percentage of revenues as a performance incentive and real estate owners receive an %earn out in the OpCo commensurate with the scale of capital invested. In more mature markets and for established brands, the operator might acknowledge the value of the investor's/ investment manager's capital with an interest in the OpCo, but they may also seek acknowledgement of the value their brand and expertise through an interest in the PropCo.

Most interviewees considered that in mature markets, there is often a gap between the investor's and the operator's perception of brand value.

Hold Co

The fourth model, 'Hold Co', addresses some of the issues arising through 'Shared Interest' models. Indeed, a number of interviewees indicated that they adopted it to avoid the complications of the 'Shared Interest' model, although it also represents a maturing of their relationship with their joint venture partners. Indeed, the growth in use of the model reflects the increasing maturity of the operational real estate sector.

In the 'Hold Co' model, the joint venture partners own the OpCo and PropCo. To some degree, this represents a reintegration of the business, depending on the structure. For example, the 'Hold Co' may represent a 50/50 split between the real estate and operating partner in terms of net revenue share, but the real estate partner also acts as the capital provider to the Hold Co and therefore receives a return on debt from gross revenue. The model is used by investors and private equity companies seeking to build scale, predominantly in the Hotel, PBSA, Senior Living and Data Centre sectors.

Interviewees employing this model all represented organisations that had restructured their businesses to align with long-term megatrend, not merely their real

> 'In the 'Hold Co' model, the joint venture partners own the OpCo and PropCo, representing a reintegration of the business, depending on the structure.'

estate allocations. An important aspect of this is replacing the silo approach to allocations by sector with a matrix of risk attributes, enabling assets with similar risk profiles in different asset class within Alternative Investments to be considered side by side and for assets with different risk profiles to be blended across sectors. In this instance, private equity with long-term income-generating real estate assets.

This realignment of business objectives and flexibility in investment allocations enables investors to reimagine their investment objectives within the broader investment opportunity identified. If the trends identify a need to develop asset anchored solutions for the needs of an ageing society, an expanding third level education sector bolstered by an expanding middle class in emerging markets and an explosion of data, then the opportunity for these investors is to participate in the delivery of the solution and own it, not merely the real estate assets. These investors anticipate that these sectors will evolve in a similar manner to the Hotel industry which over the past forty years has evolved into a small number of major players that dominate the global market, operating multiple brands and own approximately 60-70% of their assets and lease the remaining 30-40%. This view was shared across the interviewees, with respondents ranging in their assessment of the duration of that evolution with some anticipating a relatively short evolutionary horizon of 10 to 15 years, while others thought that given the fragmentation of the markets, it would take 20 to 30 years. The question for investors and managers is whether they envisage their organisation's participation in the market as a dominant owner/ operator or as a supplier of leasehold real estate. To have the objective of becoming a dominant owner occupier through the ownership of real estate anchored operational businesses requires a change of mindset, but it also requires scale. For many managers, it also requires a change of mandate, fiduciary duty and regulatory requirements. Those employing a Hold Co strategy have a scale and a new construct as part of their real estate investment objectives.

The Hold Co structure is essentially a private equity model with direct exposure to the operating business, it is a higher risk strategy than other models. However, interviewees stressed that although private equity in structure, the underlying portfolio is carefully managed with risks balanced between holdings of stabilised assets on long-term lease and management contracts, forward sale acquisitions, and develop-to-hold strategies. The focus remains on building a long-term income flow, with an additional return on the value add of the market and operational brand that the organisation's capital is helping to establish. However, the value of the Hold Co is heavily weighted to real estate assets. Unlike higher risk private equity models, there is no requirement to cash out in a 5 to 7-year horizon. In keeping with the approach to managing the number of risk dimensions taken in any one investment, this model is only employed in mature markets by interviewees.

The model also offers a number of benefits for risk management. First, with a limited pool of stabilised assets, growing scale in operational real estate markets requires development exposure, either through development, forward funding, or forward sale. By pursuing develop-to-hold strategies investors are able to participate in the value chain and benefit from the capital growth associated with building a stabilised income cashflow, with the intention to hold long-term. This benefit is shared with other models that develop to hold. Second, investors have ownership of the customer relationships and control over suppliers and procurement contracts, which underpin performance. Third, in addition to reducing fee leakage from investing in different styles of funds, or the costs of turning early-stage funds evergreen, the Hold Co structure minimises fee leakage within the investment structure and delivers full alignment between the parties. Fourth, the structure builds in flexibility upon disposal with the option to sell the Hold Co entity or to sell the OpCo and PropCo as separate entities, enabling the value to be maximised. However, depending on the market circumstances it may also be necessary to unwind the OpCo.

Section 6

Operating partner: selection, underwriting and management

Operating partner: selection, underwriting and management

> The value of operational real estate is strongly weighted to the real estate value, as well as by alternative sector.
> The requirement for an operating partner varies amongst investors and managers, as well as by alternative sector.
> The advantages of appointing an established operator are traded off against cost and investors internal expertise and resource.
> The process of undertaking due diligence on an operating partner is very similar to that employed to underwrite a General Partner for a fund.
> Investors and managers also stressed the importance of having a trusted relationship with operating partners and alignment in the vision and goals.

The requirement for an operating partner varies amongst the investors and managers interviewed, and also by sector. Several large investors and specialist managers draw on operational expertise available across their platform either from separate divisions of the organisation or from their existing capabilities in the operation of large portfolios of specific sectors. However, the majority of interviewees do use operational partners to manage all their exposures to operational real estate sectors, while all investors involve them where they lack the internal resource or capacity.

Selection

Although interviewees considered the value of operational real estate sectors as being firmly anchored in the value of real estate, the operational partner is crucial to enhancing value through delivering proficient and efficient service delivery. The role and value of the operator varies across sectors, with investment style, investment structure and investor objectives. In mature markets, market consolidation has been accompanied by a maturity curve of operating brands.

The most established operating companies have brand recognition with the customer audience, a strong track record in the quality of service delivery, multi-market expertise and strong balance sheets. These brand attributes have value and enable them to levy a higher price than less mature operators. Amongst the interviewees, they are often the preferred partners for investors and managers seeking a core income style exposure in stabilised Student Housing, Hotels and Data Centre assets, in mature markets and employing 'Leasehold' and 'Separate Entity' investment structures.

'The operational partner is crucial to enhancing value through delivering proficient and efficient service.'

'For 'Shared Entity' and 'Hold Co' models, investors and managers state that there is a trade-off between value and price that impacts on the equity split.'

For 'Shared Entity' and 'Hold Co' models, investors and managers state that there is a trade-off between value and price that impacts on the equity split. For some real estate owners, managing large global portfolios across multiple sectors in mature markets, working with a smaller number of regional operators enables more efficient management. For others, an early stage or maturing operator is preferred not merely because they carry a lower cost, but also because it is easier to develop a bespoke business model and approach that is unconstrained by systems and procedures established in a mature organisation. Indeed, it is argued that it also makes it simpler to agree equity shares when the capital pool is still in its infancy.

Due diligence

In respect of due diligence undertaken on an operating partner, the interviewees drew a parallel with the process of undertaking due diligence on a General Partner for a fund. This includes interrogating detailed financial balance sheets and accounts, track record, know-your-customer documentation and anti-corruption checks, governance policies and procedures, and checking the capability, records and trustworthiness of key personnel. It also includes establishing processes for removing the manager or dissolving the partnership for non-performance or breach of trust and setting the criteria that trigger such an event.

The interviewees also stressed the importance of having alignment in the vision and goals of the entity, and a trusted relationship. Those active in ‘Shared Entity’ and ‘Hold Co’ models are entering a longer-term relationship that requires full alignment of interest and transparency. The due diligence process reflects a private equity approach and the detailed financial analysis stress tests the operator’s business plan and projection, and interrogates the quality of existing contracts, personnel and the diversity of the client base. Whether an acquisition or a joint venture, the duration and scale of the relationship requires a cultural alignment of the organisations’ values. The capacity to build a trusted relationship to underpin what is expected to be a multi-decade business alliance is a key component of success.

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For Assisted Living and Care/ nursing Homes, the selection of operators requires financial stability and regulatory compliance as a base line, but interviewees active in this sector emphasised that their due diligence on the quality of care and services is an overriding factor. In part, this is because this sector carries higher regulatory and reputational risk, although given that the investment structures in this model are ‘Leasehold’, real estate owners are not generally exposed to reputational risks from the failings of operators. However, investors and managers argued that activity in this sector carries a social responsibility and that the social sustainability of the business is intrinsic to its financial sustainability. Although consolidation of the market is generating greater investment opportunities as operators seek real estate partners to expand in Northern Europe, investors in standing assets stated that for standing assets they trace back the geneology of operating management in each asset to better understand the underlying quality and culture of the manager. Indeed, although market consolidation brings economies of scale and shared best practice, it is not necessarily an indication of the quality of care or management at the asset level. To understand this, investors interrogate staff retention, sick leave and use of agency staff, and employ sector specialists and/ or healthcare professionals to assess the delivery of service at the asset level.

‘The quality of the relationship with the operating partner also requires management attention and the majority of investors and managers interviewed also monitor this using qualitative measures.’

Management

There are two aspects to management; the asset or entity, and the relationship with the operating partner. The management of the asset/ entity is similar to the management of other real estate assets and requires the quarterly reporting of all relevant key performance indicators and financials.

The quality of the relationship with the operating partner also requires management attention and the majority of investors and managers interviewed also monitor this using qualitative measures. These include assessing the openness of the operator regarding their operating model and the sharing of knowledge, expertise and best practice between organisations.

It is essential that the relationship develops between the organisations and is not limited to their interaction in the management of assets. Securing operational expertise is essential for investing in operational real estate, but the interviewees emphasise that their contribution is much greater than as capital a provider. If the opportunities to invest emerged from a reluctance of banks to lend to operational business and a scarcity of venture capital, the partnership of institutional capital with real estate asset heavy operating businesses has multiple synergies.

Arguably, the most important of these is investment duration, with operators and investors seeking to invest for the long-term, removing the volatility of finance and enabling operators to grow portfolios. Investors and managers are also able to contribute structuring, finance, risk management and other business expertise and can provide detailed sector and market analysis to shape the business strategy. Investors and managers are skilled at tailoring global, regional and national concepts to local markets and assessing market dynamics and affordability. They are also experienced in the development process and can bring added value to the design process, including incorporating potential for alternative use. They are also often active in multiple jurisdictions and are well-placed to contribute knowledge, expertise and transfer best practice. Equally, real estate professionals can gain insights from the operating business model and the operator's activities in other markets with the potential to transfer these insights.

Section 7

Resource implications

Resource implications

> The range and depth of the resource requirements intensify with the rate of participation in the operational business across the investment structures.
> For leasehold and separate entity structures, investors must understand and monitor the performance drivers of the underlying business model and be fully versed in regulatory requirements. This requires dedicated resource and specialist sector knowledge.
> For shared entity and hold co structures the resource requirements are wide ranging and private equity expertise is a pre-requisite. Operating a customer facing operation is resource intensive in respect of both human and financial capital; the investment scope requires scale to mitigate costs.

Investing in operational real estate sectors has implications for required expertise, knowledge and overall scale of resource across all sectors. The interviewees explained that the cost and range of this resource requirement require focus and scale. This is one of the reasons why individual investors tend to focus on selected segments that match their investment criteria and explains why all but the largest investors tend to access these markets through non-listed funds. The range and depth of the resource requirement intensify with the rate of participation in the operational business across the investment structures.

Resource requirements for leasehold and separate entity structures

These structures are primarily employed for assets that offer long, bond-like secure income streams of over twenty to twenty-five years that are attractive to long income investors. In this respect, they resemble social infrastructure investments and their underlying occupiers are often undertaking public services previously undertaken by and may remain at least indirectly, supported by public revenues. For example, Care/ nursing Homes, Assisted Living and Medical Centres/ Offices. They also may include on-campus Student Accommodation, Hotels and Data Centres. Structures employing management contracts are most commonly used with PBSA. Owners usually benefit from annualised income and appoint experienced managers to operate the assets on their behalf.

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Neither of these structures requires owners to develop an operating platform or develop internal private equity expertise. However, the operational risk to income is elevated and dependent on the operating performance of the occupier. In order to manage this risk, investors stressed the importance of fully understanding the operator’s business model and constant monitoring of the factors driving their performance.

Investors and managers indicated that real estate professionals have the required technical skills and expertise to analyse and manage these assets, but that they require deep knowledge and experience in the sectors. Embedding investments in local market opportunities is key in these sectors and understanding what drives affordability models for each sector, in each market and how to de-risk them is an important component. For example, recognising that the income of assets reliant on regional social care rates are more protected if they are within the required drive time of multiple authorities is invaluable specialist knowledge.

Many operational real estate sectors involve providing a form of residential accommodation or shelter to the public and are therefore more regulated than other real estate investments. Investors need to be fully versed in these regulations and ensure the compliance of their assets and their operating partner.

An interviewee active indirectly in these sectors stated that in addition to acquiring buy-side advice, they had doubled the capacity of their research team to enable them to fully address these sectors. Other investors and investment managers explained that they drew on the expertise across their organisations including equity analysts in REITs, Healthcare, Hospitality, Education and Technology; private equity teams and other divisions with Construction and Hospitality Management capabilities. Those active in Senior Living had expanded teams to include healthcare or healthcare real estate professionals, while sector specialists are employed for all sectors. It was generally considered that real estate professionals have the required expertise, but that there is a knowledge curve to scale. Indeed, there is a consensus that the greatest risk to these sectors is activity from generalists who may misprice or fail to understand the complexity of the value drivers.

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Resource Requirements for Shared Entity and Hold Co Structures

The resource implications for investors actively participating in the operational business are more wide-ranging and considerably more intense. Although anchored in real estate and requiring real estate expertise as detailed above, as an investment in an operational business it requires a private equity approach. Having this expertise is a pre-requisite to pursuing these models and understanding where the value and risk lie across multiple income streams in the business model and what is required to derive it. The approach requires a full business and financial plan for the growth of the operating business and for the business plan of the investing organisation.

As operational real estate businesses' are primarily customer-facing, building a business operation has a significant human resource component in terms of talent acquisition, resourcing the operation with human and financial capital across all roles, with associated legal and tax requirements in addition to training and harmonising with existing operations and corporate values. Technology is another essential element both in respect of front of house operations, customer engagement and communication, as well as in respect of payroll and tax. Once established or acquired it also requires strong systems of governance, which must incorporate managing the reputational risk a customer-facing business represents.

The enormity of this undertaking requires scale to mitigate costs. This creates further resource requirements in terms of human and financial capital as expansion requires the fast-paced acquisition (involving research, due diligence, legal and tax) of real estate across multiple locations, and the associated resource to ensure its operational success. With most operating businesses requiring two to three years before reaching a break-even represents a major commitment.

Section 8

Concluding remarks

Concluding remarks

The operational real estate sector comprises a diverse range of sectors that share five major characteristics. First, these fast-growing and evolving sectors represent real estate solutions to meet the needs of underserved demand stemming from accelerating long-term economic and social megatrends. Second, they involve elevated exposure to operational risk as the occupiers use the asset as a component of their business service, although the degree of exposure varies by sector and investment structure. Third, some operational segments can offer long-term, inflation-adjusted income with typical lease lengths of over twenty to twenty-five years, in contrast to shortening or more flexible leases in other sectors. Fourth, they offer investors a wide range of investment positions from development to stabilised assets, in emerging to mature markets. Fifth, they may be structured to clearly separate the real estate income from the operational income to enable participation in the operational income in addition to the real estate income, or to provide an opportunity to develop and grow a real estate anchored operational business.

Investors and managers vary in their investment objectives. Some consider operational real estate sectors as an opportunity to develop and own the solutions required to meet the challenges of the new economy and society, not merely as the real estate component. They aim to expand participation in the value chain they are facilitating, to create the real estate and deliver the service solution, with aligned venture partners where required, and to grow scale to become a major owner/ operator of these emerging industries as they expand in the coming decades. This represents a shift in investment mindset and mandate, repositioning real estate away from being a product, and embracing the delivery of real estate space as a service.

Other investors and managers also recognise the distinction between product and service, but prefer to restrict their activities to a lower risk and lower return strategies from delivering the real estate component to the real estate anchored business. For some sectors, this is because the operational business is highly specialist, particularly in respect of the delivery of specialist care. It is also true for investors seeking a core income style return and those whose mandate, fiduciary duty and/ or regulatory constraints require their return to be derived from real estate and within prescribed risk parameters. Investment structures also offer investors a range of risk positions.

> ‘Opportunity to expand participation in the value chain to create the real estate and deliver the service solution of the emerging new economy.’

> ‘Shift in investment mindset and mandate, repositioning real estate from being a product and embracing the delivery of real estate as a service.’

The options of real estate as a product, real estate as a service, or real estate with a service are rapidly evolving as characteristics of all real estate sectors. Business life cycles and lease lengths are becoming shorter in traditional sectors, regardless of whether real estate is a core component of the occupier’s business offering. In major office markets with strong underlying demand, a diverse occupier base will likely continue to enable market rents to be determined by comparative transaction evidence. Even then the push for more occupational flexibility is likely to continue to distort the traditional supply-demand metrics. This is in parallel to the rapidly evolving intermediary office space service providers. In all other markets and sectors, understanding the drivers of the affordability model of underlying occupiers’ businesses will be key to assessing affordable rents, estimating potential growth and managing risk. Delivering space as a service either directly or indirectly through an intermediary may be essential to adding and protecting value.

Appendices

Appendix 1. Structure of interviewee sample and discussion

The research is primarily based upon the analysis of twenty-two structured interviews undertaken between June and August 2020 with investors and investment managers active in the alternative real estate market in Europe.

Seven investor participants representing large pension funds, insurance companies, and sovereign wealth funds head-quartered in six different countries, each with a global investment strategy. Three multi-managers also contributed to the interviews who, in addition to their experience of the market, provided insights from the perspective of a wider range of investors by scale. A total of twelve investment managers across five European countries were interviewed, comprising large platforms with a global mandate, medium scale organisations active across Europe, and niche platforms active in specific sectors and/or specific markets.

The interviews explored the what, where, why and how of alternative investing by investigating: What sectors and segments investors are targeting; In which regions and/or locations; The underlying investment rationale and objectives; and, How investments are structured and managed, noting the implications for required expertise.

Appendix 2: Comparison of risk characteristics of operational real estate sectors

	Sub-Sector	Location	Source of Operating Revenues	Operational Specialist Expertise Requirement (beyond Facilities Management)	Exposure to Operational Risk
Hotels	Full Service	Lesiure or business; Urban centres or Resort;	Operator or Diverse revenue streams from occupancy, F&B, events and leisure	High	Direct/ Indirect
	Standard Business	Urban Centres; Airports and Gateways	Operator or Diverse revenue streams from occupancy, F&B, events and leisure	High	Direct/ Indirect
	Budget	Urban Centres; Airports and Gateways	Operator or Revenues primarily reliant on rates and occupancy	High	Direct/ Indirect
	Hostels	Urban Centres	Operator or Revenues primarily reliant on rates and occupancy	High	Direct
	Camping	Resort	Operator or Revenues driven by occupancy and services	Medium	Direct
Student Housing	PBSA (International)	Urban Centres and on/ adjacent to Univrsity Campus	Revenues primarily reliant on occupancy; blurred boundary with Budget Hotels and Micro-living	Medium	Direct
	PBSA (Domestic)	Urban Centres and on/ adjacent to Univrsity Campus	Revenues primarily reliant on occupancy; Blurred boundary with Hostels	Medium	Direct
	On Campus	Unversity campus	Revenues primarily reliant on occupancy	Medium	Indirect
Niche PRS	Co-Living	Urban Centres	Revenues primarily reliant on occupancy; blurred boundary with Budget Hotels	Medium	Direct
	Micro-Living	Urban Centres	Revenues primarily reliant on occupancy; blurred boundary with Budget Hotels	Medium	Direct

Senior Housing	Senior Living	Suburban and Urban	Revenues reliant on unit sales/ occuancy, event fees and services	High	Direct
	Assisted Living	Suburban	Revenues reliant on occupancy, social care and private pay	High	Indirect
Healthcare	Care/ nursing Homes	Suburban	Revenues reliant on occupancy, social care and private pay	High	Indirect
	Residential Care/ Psychiatric	Suburban	Revenues reliant on occupancy, social care and private pay	High	Indirect
	Medical Offices/ Centres	Urban/ Suburban	Revenues reliant on occupancy, social care and private pay	Low	Indirect
Data Centres	Data Centres	Urban/ Suburban	Revenues reliant on data volumes and energy capacity contracted	Medium	Indirect

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