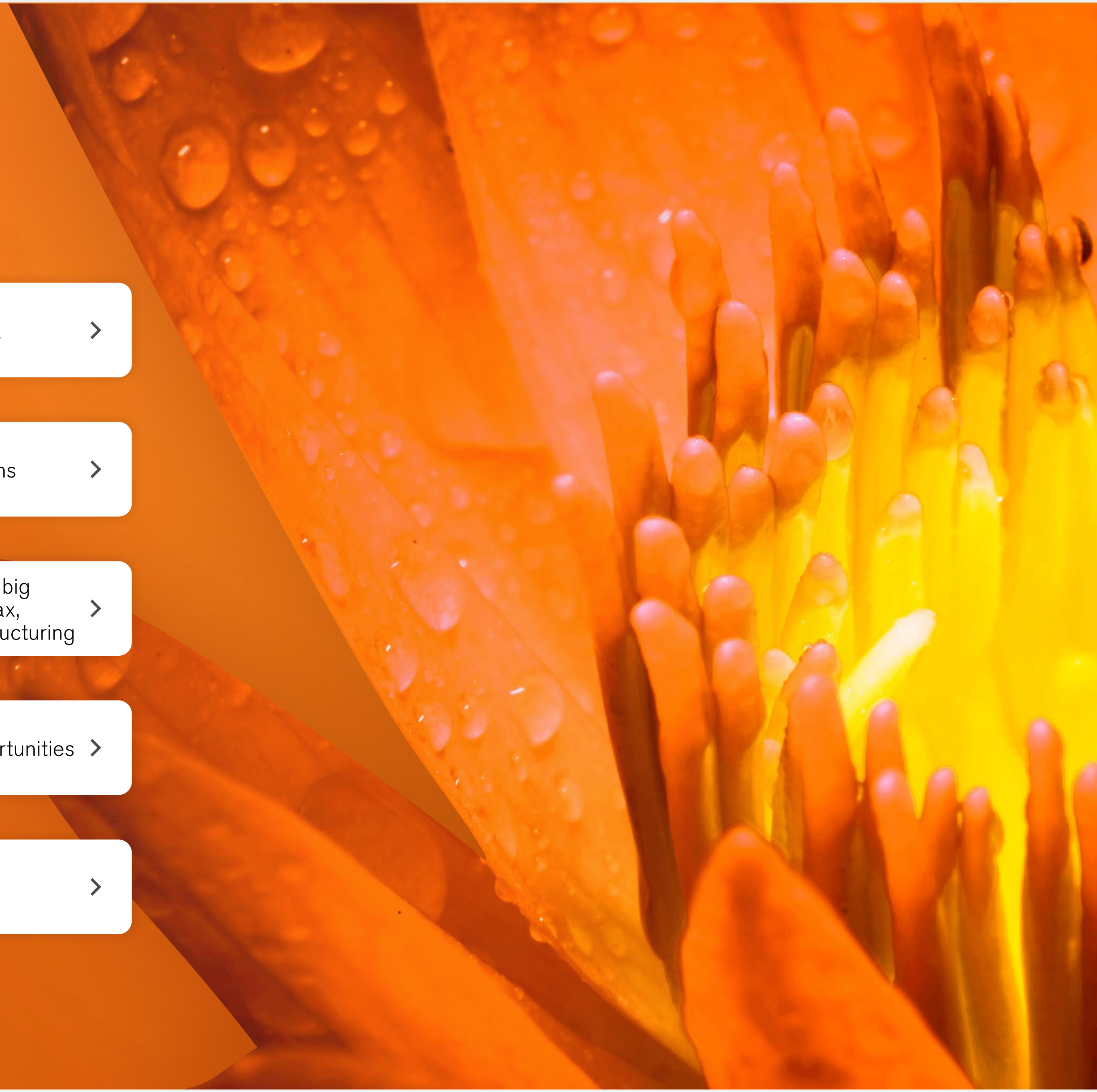
MACFARLANES

Operational real estate

Read on

macfarlanes.com

Contents



Foreword

In today's real estate market, many of our clients' real estate assets are increasingly and inextricably linked to operational platforms, partners and the end users of the real estate that they serve. At Macfarlanes, we have long recognised that this structural shift towards operational real estate requires us to adapt as advisers, to best support our clients in responding to the unique drivers that operational investments present.

This report has been produced in conjunction with Montfort Communications in response to the growing awareness of the role that operational real estate plays in today's market, to identify the market opportunity and key considerations and challenge some of the misconceptions.

Over the past six months we have interviewed a variety of market-leading stakeholders, including investment managers, operators, specialist asset managers, advisers and lenders and collated their perspectives and insights. The result is a deep dive into today's operational real estate market, including the scale of the market opportunity, an analysis of how such investments may be accessed and an overview of some of the key structuring and governance issues market participants are grappling with.

A number of our valued clients and contacts have contributed to this report and Macfarlanes would like to thank them for their time, advice and enthusiasm for this project.

- Mary-Anne Bowring, Ringley Group
- Emma Parr, Birchwood
- Lorna Brown, Birchwood
- Charles Ferguson Davie, Moorfield Group
- Charlie Gayner, re:shape and ARK
- Andrew Lawrence, Sadel Group
- Simone Pozzato, Hines
- Ryan Prince, Realstar

Whether you are a new entrant to the operational real estate market or an experienced participant, we hope this report provides a useful reference point and stimulates further conversation about how the real estate investment market is evolving. We would be delighted to discuss how any of the matters raised in this report apply to your business.

About Macfarlanes

Macfarlanes is a London-based law firm which occupies a distinctive position in the London legal market. It offers a broad range of legal services in relation to both domestic and international matters, combined with an agility and culture to meet the most challenging demands of the changing world. While many of its services and expertise can be found at other firms, the mix cannot.

About Montfort Communications

Montfort Communications is an award-winning reputation management consultancy, delivering data-driven strategic advice to the world's leading companies, individuals and organisations. Led by one of the most experienced leadership teams in the industry, it combines significant experience with dynamism and fresh perspectives.

2

Introduction

The opportunity in OPRE

The shift to operational real estate (OPRE) is probably one of the most important structural changes in real estate at this moment, though you could be forgiven for not knowing it.

A real estate asset is considered "operational" when income and values are linked to the performance of the underlying operator.

In a conventional real estate investment, rents rise irrespective of the performance of the underlying occupier or operator. This is not necessarily the case for OPRE, however, which brings the physical real estate and its underlying operations closer together and in doing so provides the ability to enhance returns.

Traditionally, OPRE has been closely associated with the alternative sectors, but its core premise of establishing a closer relationship between the occupier or operator of the building and the "bricks and mortar" may be applied across both traditional and alternative real estate sectors.

We believe that OPRE is going to be a key feature of the owner/occupier relationship in real estate going forward.

Setting the scene

It often takes economic headwinds to refocus investors' minds on the fundamentals.

The outlook for the immediate future is for little capital growth and more income risk. As in 2008, in such an environment, asset management will become the focus of investors and managers, looking to demonstrate they are taking a hand in the running of their assets.

OPRE structures are a natural progression of such an active approach to asset management, allowing managers and investors willing to accept the different risk profile that comes with OPRE investments the opportunity to enhance their returns.

Post 2008, there was an explosion in investment into sectors such as student accommodation and senior living. This was driven by both structural megatrends and a chronic shortage of supply, but it demonstrated the advantages of OPRE models to the market.

Already in 2023 we are seeing a further refocus on asset classes that allow management upside, including build-to-rent (BTR), co-living, storage and life sciences. These capital flows are underpinned by structural changes but it's the operational features of such investments that allow them to act as an inflation hedge in times of market turmoil and tap into the performance of the underlying businesses.

The reason alternatives have led the way is because their business models are often inherently well suited to OPRE: a co-living block can increase income through amenities and professional management; or a hotel may drive occupancy rates through operator brand, booking platforms and design specification. There is nothing, however, to stop an operational investment approach being applied to a retail asset, where active management of a shopping centre to curate a customer experience can add to footfall and tenant incomes.

As investors gain familiarity with OPRE structures – and operational models are seen as increasingly part of mainstream investment strategies – the development of the market will continue.

Accessing operational real estate

The diversity of the emergent OPRE landscape, in terms of operators, sectors and investment structures, combined with the lack of industry guidance and transparency to date, means that there is no "one size fits all" approach.

Much depends on the type of operational structure employed. OPRE structures may range from relatively passive exposure to owning an operating business; from rent linked to the turnover of the operator, to joint ventures and service agreements, to alignment through an equity interest.

The most suitable investment model is often determined by an investor's ability to assume operational exposure, balanced against their appetite for driving their investment returns and potentially capturing any economic upside created in the operating business itself.

Rewards worth the risk

Investors and managers are increasingly concluding that the rewards of OPRE justify the different investment risk profile, with significantly greater upside potential and the ability to drive income returns in an otherwise challenging market. The product of an operator when combined with real estate is often far greater than the sum of its parts.

The potential market size is compelling. In the UK alone according to research carried out by Montfort Communications, the combined value of alternative sectors today is in excess of £240bn. The market value could increase to well over £750bn if we reached the levels of saturation seen in other countries and current growth trends continue.

In this report we will focus largely on the alternative sectors and those investment models already in existence, explaining how they have worked and how they can be accessed. But there is nothing to stop this practice being copied and applied across traditional real estate sectors.

As we said, operational real estate is perhaps the most important structural shift you have never heard of.

Potential size of UK operational markets in selected alternative sectors

Sector	Current size (£bn)	Potential (£bn)
BTR	56	280
Purpose built student accommodation (PBSA)	72	110
Co-living	1.4	18
Senior living	34.6	160
Hotels	20	48
Co-working	5	15.8
Self storage	11.6	30.6
Cold storage	9.6	10.5–14.4
Single family housing	5.6	28
Data centres	27.5	55
Total	**243.3**	**759.8**

Sources and methodology:

Subjective analysis carried out by Montfort Communications (2023). Data used from Savills, JLL, KF, LGIM, Shawbrook, HESA, Research and Markets, CBRE, Cushman & Wakefield, Safestore and Colo-X.

Current market values are taken where possible from existing estimates and otherwise extrapolated using market sizes, average unit values and income. Future values are obtained assuming the UK sees the same level of development as other more developed markets or are based on existing accepted market predictions.

The principal actors

In simple OPRE models we can assume two to three principal participants: investors, who commit capital to investment strategies; managers who manage those strategies; and operators who provide the specific, operational expertise in respect of the real estate assets.

Investors

Objective

Using OPRE to maximise returns in accordance with risk appetite.

Key considerations

- Appetite for exposure to operational risk.
- Capital allocation considerations – does the operational nature mean PE rather than RE classification from an internal or regulatory perspective?
- Ensuring the correct valuation methodology for an asset's operational component.
- Ability to understand and oversee operator performance.
- Effectively measuring risk and return considerations against capital deployment requirements.
- Ability to access debt.

Managers

Objective

Using OPRE to maximise returns in accordance with defined risk appetite and investment strategy.

Key considerations

- Defining the optimal structure for accessing OPRE in the context of investor preferences and strategy.
- Identifying and ensuring exit strategies to enable the realisation of an investment.
- Effectively addressing and discharging fiduciary duties in the context of OPRE.
- Effective appraisal of operational risks as part of investment due diligence.
- Effective oversight and monitoring of operators on behalf of investor.

Operators

Objective

Ensuring the success of their operating business.

Key considerations

- Strategy for growing the operating business – will the investor or manager require that any restrictive covenants are entered into regarding operator's activities?
- Whether appropriate for the investor or manager to also take equity interest in operating business.
- Agreeing a correct compensation structure for providing operational services, both in terms of base fee and any performance related component.
- Developing and managing operator USP and branding.
- Delivering business continuity.

The what, why and how

What is OPRE? - Understanding the "hotelification" of real estate

A real estate asset is operational in nature when income and values are to some extent linked to the performance of the underlying operator.

The European Association for Investors in Non-Listed Real Estate – better known as INREV – defines it as: "An investment in a real estate asset structured so as to create a strong correlation between returns to the asset owner and the underlying operational performance of the operator or occupant".

Put simply, it's about aligning a property's returns with its operational performance.

In BTR, a well performing asset will have low vacancy rates, happy tenants and short void periods. A well-operated hotel results in high occupancy rates and busy restaurants. In cold storage, full and efficient warehouses. In all these cases, if the operating entity is run well, a higher income return is generated for the real estate and the value of the asset increases.

For many real estate investors, the immediate association would be turnover rents, but OPRE extends well beyond passive contractual mechanisms.

Depending on the structure used to access OPRE investments, (explained in detail on page 11) investors and managers can obtain varying degrees of visibility and control over the day-to-day asset operations. Cynics could call this meddling, but it can lead to a far greater alignment between the interests of an investor and the underlying occupier. That can translate into better security of income and the chance to drive returns and enhance values.

In essence, OPRE provides the opportunity to derive more value from a real estate asset.

> "Generally speaking, you should be able to generate a better cash flow, and that better cash flow comes from the fact that you are managing the operations, so you're adding an operational risk on top of the standard risk that a core real estate investor is taking.
>
> **Simone Pozzato**
> MD – HECF Fund Manager at Hines

Structurally supported growth drivers

The rise in OPRE has been intrinsically linked to the rise of the alternative real estate sectors, which in turn have experienced a period of rapid growth, underpinned by structural trends.

"Sometimes we've invested in operational real estate because that's the only way to access a sector," says Charles Ferguson Davie, Chief Investment Officer at Moorfield Group.

In order to access many OPRE sectors, investors have had to access operational expertise, either by using their own management companies or by engaging external operators. For many this has been their first taste of OPRE.

"I'd say that all real estate is becoming more operational," says Ferguson Davie.

"But alongside that you also have the case that there's more investor enthusiasm in some of these more alternative, new and emerging sectors."

From buzzing student halls to humming data centres, the common thread has been an operational entity that runs the building and acts as the interface with its occupiers. It's the successful operation of this company that makes the asset as a whole profitable.

The present day

Fast forward to the present day and there are further drivers behind the growth of OPRE, as it branches out from the alternative sectors.

Firstly, there is the benefit for managers and investors. Anecdotally, some say they can achieve returns 20-30% higher than in a conventional real estate investment model.

Speaking about their Aparto student housing arm, Simone Pozzato, MD - HECF Fund Manager at Hines, says that an operational business taken in isolation typically has a cost intensive structure. But this can have a transformative effect on real estate returns when combined with the real estate asset itself.

"The asset manager that can efficiently and successfully manage the operations will then benefit from better performance at the asset level and will enjoy better economics overall," he says.

Secondly, the investment market is becoming more sophisticated and exacting. Investors expect managers to actively manage assets and demonstrate what strategies and direct interventions they are making to drive returns. OPRE provides a natural platform for this.

Thirdly, there are the demands of the occupier market itself. Shorter, more flexible and responsive leases with service led options are in demand across many sectors.

It's both a sign of the economic climate and a natural evolution in consumer preferences, not to mention a financial imperative, as new accounting rules means long leases are accounted for differently. A more "hands-on" operational model, often employing technology at the occupier interface, is well suited to managing such higher rates of tenant churn.

Finally, and perhaps most importantly, there is the economic context. In today's challenged market, sustained higher interest rates have squeezed returns and capital appreciation is expected to be limited. The focus has shifted to cash flow growth. OPRE structures permit hands-on management of income and a chance to align the returns of the asset with the returns of the operator.

> "There's been a perfect storm in the growth of OPRE. More investment into alternatives, greater investor sophistication and increased occupier demand are all driving growth. Now, in a less sure market, that early work means an investment model that steps away from traditional, passive real estate and provides investors with an opportunity to grow returns by getting their hands dirty.
>
> **Dan Marriott**
> Partner, Macfarlanes

A core selection?

Historically, the hands-on nature of OPRE and its different risk/return characteristics has led many to classify it as value-add in nature. However, as income becomes a particular focus for investors and managers, many are reappraising whether OPRE has a role in core portfolios, particularly in more mature, operational sectors. This is explored in more detail in section 5 of the report.

Beyond investment classification, equally important is thinking differently about how existing core assets are run and whether they could benefit from an operational component. Increasingly, investors and managers are concluding that offices and retail assets could be made stabler and their income returns improved with a well-run operational management structure.

"A lot of what has been learnt about in operational real estate is now being applied to both traditional and emerging sectors," says Andrew Hughes, Partner at Macfarlanes.

"There is the opportunity to treat every asset like a business, with thought given to design, technology and branding, but with a focus on operational structures and incentivisation to get the most out of everyone on site."

A hotel example

Struggling to visualise a working operational model? Picture a hotel, where an investor owns the real estate and an operator is engaged to provide operational management services for the hotel itself.

The typical operational services of a hotel include all aspects of day-to-day management: operations, staffing, marketing, planning, supplying, equipping and repairing. There is also likely to be a set standard which the operator has to meet when providing services, particularly if it is operating a well-known brand in the market.

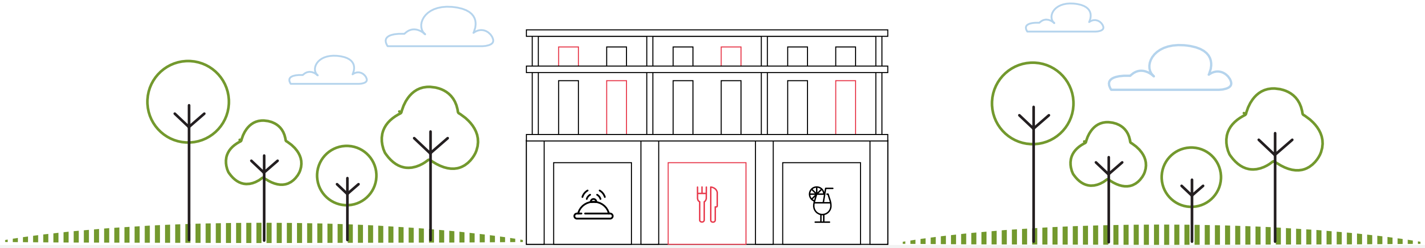
A typical fee structure sees the owner collecting the hotel's revenue, while the hotel operator receives a percentage of revenue as its basic fee – the "base fee" – plus a percentage of gross operating profits – the "incentive fee".

The base fee is designed to cover general management costs, while the incentive fee aligns the interests of the investor and the operator by incentivising performance.

Work in positioning and upgrading the hotel – both physically and through branding and marketing – will likely lead to increases in rents, income and occupancy, increasing the income of the operator, while also contributing to an increase in the capital value.

The use of an operational management agreement enables the investor to not just passively profit from higher income. In fact, in taking on the income risk of the asset, through investment and joint positioning, they have been able to increase values and overall returns of the asset in addition to direct cash flow.

This is a simple example with just two actors and a deeply simplified contract. In reality there are a huge amount of deal types and management structures – but it is all about taking on a more active role in running an asset.



Sectors and drivers

Sector evolution	Sector	Drivers
Nascent		
Few operators available.	Vertical farming	Underpinned by concerns over food security and global competition for resources.
	Media/film studios	Driven by demand for content creation and growth of online streaming platforms. Potential scale of UK market to be determined.
	Co-living	Immature sector with potential for professionalism. Intensive management with potential for upselling. Demand for professional product in HMO (house in multiple occupation) sector.
Scaling		
Growing external alongside in-house operational management.	Single family housing	Works in conjunction with housebuilder models to increase supply and additionality. High demand underpinned by fundamental housing under-supply in UK.
	Cold storage	Already established market backed by food supply security concerns.
	Senior living	Huge potential market driven by an ageing population. Recognised and supported by Government, most recently by the Mayhew Review. Diverse opportunities for investment with varied occupier requirements.
	Leisure	Established market with variety of sectors, from gyms to golf courses and trampoline parks. Varying levels of maturity.
	Data centres	Growing market buoyed by digital demand and growth. While complex in terms of power and security, increasingly supported by Government.
	Life sciences	Established sector with organic growth around university clusters. Potential for private sector expansion based off US model which has adapted to the complex range of occupier demands.
	Co-working	Growing and in demand sector backed by changes in working practices. Popular with small and larger companies. Divided into co-working and serviced offices.
Mature		
Variety of operational management structures to represent risk appetites.	BTR	Increasingly understood and sought after housing tenure with growing proven physical examples across the UK. Evidence of Government support.
	Self-storage	Growing popularity with proven management. Established companies already present but still a growing market with potential for expansion and increased sophistication.
	Student	Mature market underpinned by university demand and UK reputation. Opportunity for up-selling and inflation linked renting.
	Hotels	Mature sector with developed investment and transactional market. Large number of operators adapted to the educated and demanding consumer market.

4 Routes to accessing OPRE

The route chosen by an investor to access OPRE will be a function of their particular investment perspective and risk appetite.

A critical understanding in OPRE is that the value of the real estate asset is more closely aligned to the success of the operator. As such, key to any structuring consideration is the "tying together" of the operator and the real estate to ensure mutually beneficial objectives. The right structure needs to be chosen for the right investment and inevitably there can be a bewildering array of considerations.

"Investment structures can range from relatively passive hybrid leases to management contracts to full on vertical integration when a company is brought "in house" and owned and managed exclusively by either the investor or manager," says Dan Marriott, Partner at Macfarlanes.

"However, in a simple model there are three primary variables which can determine an optimal investment structure: the level of equity, the maturity of a market and the tolerance to risk."

Step 1. Equity

The first question is how much of an equity interest, if any, is an investor willing to take in an operator? This can define the level of visibility and control over the operations of an asset but also enables an investor to capture any value generated within the operating business itself.

Is the right model an operational management agreement, a JV with an operator or an "all in" vertical integration approach, where the operation of the asset is brought within the investor's or manager's own value chain?

"You have a decision to make with operational real estate, which to a certain extent is also true of traditional real estate, and that's whether you also own the platform that oversees the operations of the asset" says Charles Ferguson Davie, Chief Investment Officer at Moorfield Group.

Step 2. Market maturity

The approach to equity exposure of an operating business is also informed by the relative maturity of the sector being invested in and the "fungibility" of the operator.

Are there already operating businesses in the sector, or is it unexplored territory? Do the operators in existence offer an investable product? Can they work across portfolios or are they asset or market specific?

"At the time we started [residential rental brand, UNCLE], there weren't really any third-party operators, so we didn't have much choice. Now, we think we're a market leader and our skills are a competitive advantage for sourcing, underwriting and of course generating high quality cash flows," says Ryan Prince, Chairman at Realstar Group.

In a nascent market, where there is not a deep pool of substitute operators, investors are likely to be more cautious. They will want to ensure the operator is appropriately tied to the real estate assets, either through contractual provisions, an equity interest or by bringing the operational capability "in house".

Step 3. Defining risk

Finally, there is the risk appetite of the investors themselves. OPRE investments entail a different bundle of risks when compared to conventional real estate investments, for which investors will have varying degrees of enthusiasm.

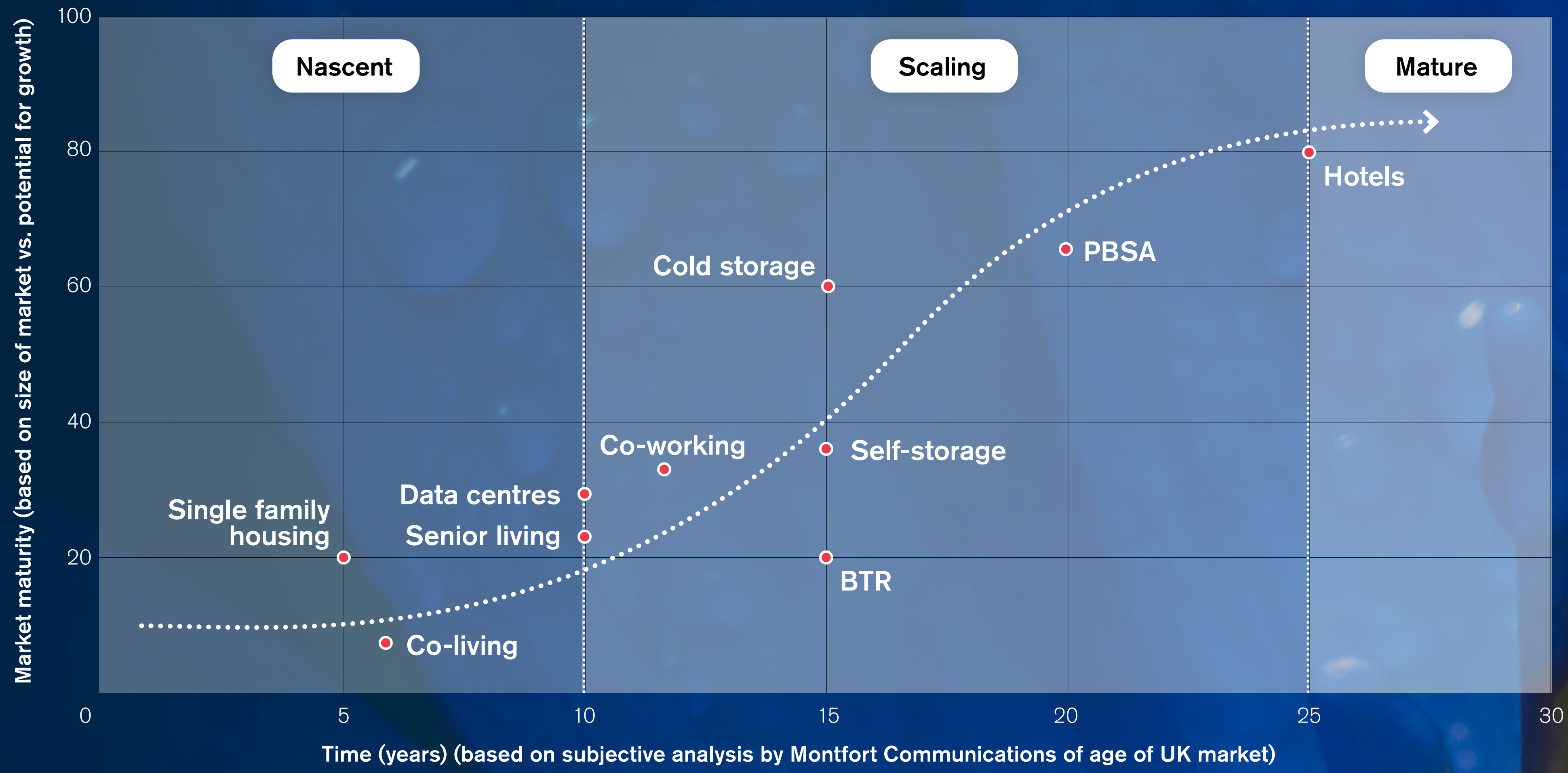
Levels of exposure to an operating business, market maturity and the certainty of future income are key factors which make up the particular risk/return profile of an OPRE investment.

For example, how comfortable is an investor with employee related risks usually entailed in exposure to an operational business? How comfortable is an investor with the reputational risks that may be entailed in a closer association with an operational brand that has the consumer interface?

In turn, the different risks presented in OPRE require different approaches to investment due diligence. In comparison to a conventional real estate asset, due diligence becomes more complex.

After looking at the different equity structures and market maturity, it is the investor that will need to decide if the levels of risk match up to their objectives and investment profile.

The potential for growth in different markets



The spectrum of access: from a contractual relationship to vertical integration

The desired level of operational exposure, the maturity of the sector and depth of operator pool – not to mention the expertise of investors and their appetite for risk – are some of the factors that influence the route to access.

Below are the main structural routes that an investor can use to buy into OPRE, with an investor's exposure to upside and downside increasing as it moves along the scale from landlord to owner/operator.

Indirect exposure

Fund investment

Indirect exposure by investing in funds with operational exposure – which themselves can take any of the structures listed below – where the fund manager typically oversees the operator. Funds may contract with an operator to provide services or even look to own the operator itself on behalf of fund investors.

Lending

Provides operational exposure from a more protected part of the capital stack. Can require extensive due diligence centring around the operational competence and experience of an operator alongside the viability of a corporate business. Debt is a contractual interest with the potential to be converted into equity control should a security interest be enforced.

Direct exposure

Turnover and hybrid leases

Investor's return is intentionally linked to the income of the underlying business. More complex models can include other income and value-add opportunities. Can vary considerably but a common feature is that all or part of the rent is based on an agreed percentage of EBITDA.

Franchise

A franchisor can license its know-how, procedures, intellectual property (IP), brand, and rights to sell its branded products and services to a franchisee. The model is often used in the automotive, hospitality, leisure and retail sectors.

Joint ventures

Can take a variety of forms and may include both equity and/or debt exposure to an operator alongside a detailed contractual framework for how the two parties will work together in the context of the operational venture. Investors can create bespoke exposure to operational aspects of an investment and obtain a greater degree of control and visibility.

Sale and leaseback

An asset is sold to an investor then leased back to the operator for a defined period of time. Common in student and healthcare. Wide spectrum of deal types and not all are operational. Significant potential in deals to create operational structures where fund takes some of rental upside in exchange for improvements or additional facilities.

Operational management agreement

Originally developed for hotels. Owners of real estate pay a fee to a management company for operational services. As with a franchise, the investor is generally responsible for all operating costs and repairing liabilities and, therefore, carries the operational risk for the property.

Equity share

Investors take an equity share in an operator which can align business objectives and enable the investor to share in any upside generated in the operator, while taking on more of the operational risk.

Platform creation, M&A and vertical integration

The investor is the operator. Investors acquire operators and build scale through M&A (or existing managers expand into acting as operators). A vertically integrated operator can have its objectives and operations fully geared to the real estate asset and play a more active role in asset design and development.

5 Fund structures and classification – can OPRE be core?

The journey to institutional capital

As many OPRE investments have their origins in nascent, alternative sectors, traditionally their risk profile has been seen to be more compatible with value-add or even opportunistic investment strategies. Historically, it has largely been private equity investment houses who have been most comfortable underwriting such operational risk. However, there are signs of this changing.

"We're getting to a situation where core investors will need to get their hands into operational real estate more," says Simone Pozzato, MD – HECF Fund Manager at Hines.

"At the end of the day, the core investors – pension funds and insurance companies – are the ones more interested in enhancing income returns in their investments."

For institutional investors, a movement into OPRE investment is unlikely to be without its growing pains.

Even if such investors get comfortable with the risk and return profile that OPRE presents, allocation issues – driven by either internal or regulatory considerations – may make it difficult for OPRE investments to be made out of the real estate "pot of capital". This can result in OPRE investments being pushed into the private equity bucket for capital allocation purposes and competing for investment in a pool of higher returning investments.

"Some real estate investors can invest in real estate funds, but can't invest in the opco, for example, because that's classified as private equity for them," says Pozzato.

"And then you are redirected to their private equity team but for them it's not interesting business because they invest in private equity funds and they are not real estate experts. They're not there to assess the quality of the assets AND the operations."

Internal allocation challenges may ease however as institutional investors increasingly regard operations as a common feature of real estate investment across a range of sectors.

What makes an OPRE asset core?

Income and its management sit at the centre of the debate as to whether OPRE assets may become core in nature.

Core strategies require a high proportion of their return to be derived from income and from assets that sit at the lower end of the risk spectrum. Core investors want stable, reliable cash flows with little requirement for immediate capital expenditure. On the surface OPRE offers a chance to tap into income and its growth.

"One of the benefits of the more operational real estate sectors, if they're in the right sector, is supply-demand mismatch and growing demand. Because you can reset your rents regularly, you get that inflation regrowth, and so that can offset some of the movement in yield and funding costs," says Charles Ferguson Davie, Chief Investment Officer at Moorfield Group.

> "The high degree of occupant "churn" that is a feature of sectors such as BTR, co-living and co-working may seem to be at odds with the stability of a core asset. Despite this, a well-run, operational asset can provide stabilised income streams which both mitigate risk and tap into potential upsides. Operational assets, correctly positioned in terms of service offering and pricing, can ensure continuous demand and lower void rates, while at the same time, shorter-term tenancies can provide an effective inflation hedge.
>
> **Andrew Hughes**
> Partner, Macfarlanes

To help the transition to core, there is a checklist of factors for an asset and its operational structure

1. **Stable cash flows and a track record of low void rates**
2. **Established brand with associated marketing operations**
3. **Efficient operational systems, processes and technology**
4. **High levels of consistency, transparency and accountability**
5. **Valuation certainty**

"At an early stage of creating a portfolio, you want to make sure that you're building the right foundations across brand, data, technology, and customer experience so that at point of sale there is consistency and efficiency in how the portfolio is managed," says Charlie Gayner, Co-founder of re:shape & ARK.

"This will enable initial private equity investors to easily handover the keys to an institutional investor to then hold the assets and collect income."

The presence of these factors may help core investors to come to terms with assuming operational risk and provide the desired risk and return trade off. However effectively conducting due diligence on such assets will require new methodologies and financial metrics to be considered by investment teams. For many core investors this may require a "cultural leap" to be taken in terms of how they conduct their investment activities.

Investors and managers who have brought operational expertise into their business, to work alongside their conventional real estate capabilities, may find this transition easier than others.

"It's often a lower margin business. But the asset manager that can efficiently and successfully manage the operations will then benefit from better performance at asset level and will enjoy better economics overall," says Simone Pozzato, MD - HECF Fund Manager at Hines.

"I'm quite lucky because my boss, our European CIO, is Alex Knapp who set up aparto, our student housing company in Europe, so he knows exactly what we're talking about when we're discussing operational real estate."

Defining the fund and exit structure

Robert Porter, Senior Consultant, Macfarlanes

"When structuring any real estate investment there needs to be consideration to how the exit will ultimately be achieved. This is especially true for OPRE.

As the operational component of an OPRE asset is so intrinsically linked to its value, during any exit strategy there is understandably a need for a higher focus on the continued performance of the operator.

Classic, private equity style investments have made up much of the early investment into operational sectors. These are often held in limited life, closed-end funds, with assets either disposed of at the end of the funds life into the market, or, with growing frequency, by way of a GP led, secondary transaction.

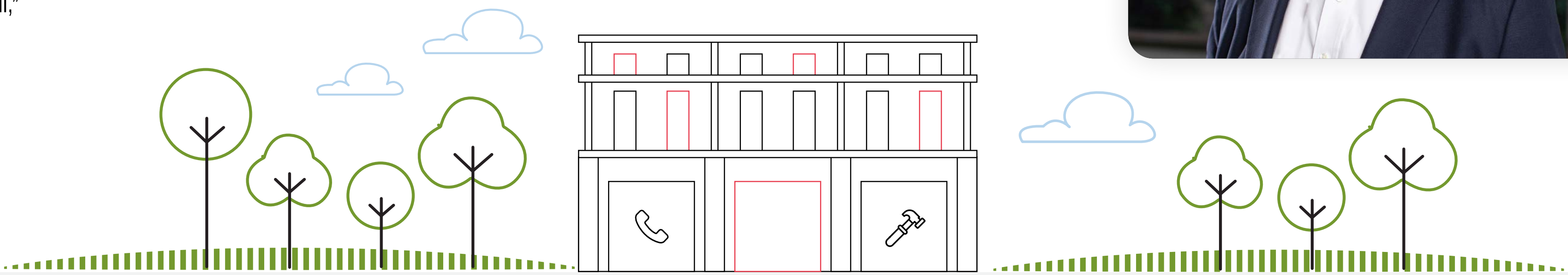
Any buyer will want to ensure the operator is effectively tied to the assets and not disrupted by any change of overall ownership, but this can be complicated by the different operational ownership structures.

For instance, when the manager owns the operator through a vertically integrated management model they have a fiduciary obligation to act in the best interests of investors. But if a buyer wants to retain the incumbent operator the manager will have an interest in negotiating the continued involvement of the operator in the assets post-sale.

The interests of the manager can diverge from those of the investors and as such need to put in place robust processes to effectively identify and manage conflicts of interest. This could take the form of separate teams internally to keep competing interests distinct, but there is no one size fits all answer.

Some funds prefer not to own the operational platforms outright, while others see owning and controlling the operator as the best model to ensure they are effectively discharging fiduciary obligations to investors.

Going forwards we expect to see more OPRE investments, particularly in more mature operational sectors, to become an increasing feature of the core, open-ended fund universe in Europe. Alongside a general trend towards longer term capital vehicles, such vehicles are inherently better suited to retaining incumbent operators.



Considerations by method of accessing OPRE

	Turnover rent	Management contract	JV with operator	Platform/M&A
Explanation	Rent linked to occupier's gross turnover at property, but otherwise no operational involvement.	Operator engaged as a third-party service provider to asset owner.	Equity or contract based joint venture with an operator. Provides greater level of control and transparency.	Operator is owned and controlled by fund/manager/investor owner and benefits from its services.
Accessibility	Established and well understood mechanism.	Common entry point to OPRE in developed market.	Requires investment into relationship with operator, documentation and governance.	Needs significant capital and resource investment. Scale needed to justify resource commitment.
Control	Varying degrees of control set out in context of landlord and tenant relationship.	Operator control and oversight governed by contractual obligations.	Rights of control set out in JV. Can include board representation and positive/negative control rights. Can also control operator pipeline through ROFO or similar.	Complete control over operational business – from service to specification of product. Also control operator pipeline.
Other potential risks	Little management influence and increased rental volatility.	Do core functions or assets need to be retained to protect asset values? Operator visibility on operations and governance needed.	Operator services and rights regarding IP and data ownership to be defined. Are services provided exclusively to fund?	Fund risk profile changes from conventional RE to more "private equity" in nature. For example, employee risk and higher cost base.
Linkage of operator and assets	Typically some negative control e.g. limited ability to assign lease.	Scope of management agreement to be defined. Change of control provisions in respect of asset owner may be inappropriate, particularly if a shallow pool of operators.	Typically a closer linkage between operator and assets. May be able to build further covenants into agreement to further define relationship, e.g. sourcing of new opportunities and resourcing.	No separation of ownership between manager/asset and operator. No recourse to third-party operator. Consideration to be given as to how operator oversight and accountability is achieved.
Transparency	Limited to typical lease provisions.	Governed by management agreement.	Reporting to be set out in JV and may be further enhanced by information obligations and board representation.	Higher levels of transparency.
Operator fungibility	If limited pool of tenants, ability to enforce may be limited.	Risk dependent on number of operators and maturity of sector.	Operator can be more closely tied to assets through JV agreement, reducing risk.	Protects against risk of few replacement operators. Gives chance to influence product/brand.
Incentives	Variable rents can incentivise performance.	Fee structures and investment milestones can be used to incentivise operators.	Can incentivise with fees but also create share in asset value created.	Alignment between RE ownership and operator.
Return impact	Limited to share in turnover.	Enables investors to drive income but not to share in any rise in operator value.	Depending on structure, can capture upside created in operator.	Through equity alignment, share in value created and also downside risk.
Exit	Landlord interest would be sold. Exposure to occupier turnover "entrenched" in lease provisions.	Possible owner exposure if value associated with operator. Mitigated in service agreement termination provisions.	Operator likely to be more entrenched with asset and transferred with ownership. Needs to be pre-agreed.	Operator and real estate may be "tied together". However not all buyers want to take on operating business.

6 Lending and OPRE

The increasing prevalence of OPRE means a willingness from lenders to explore operational opportunities. This is especially true in the context of the growth of the alternative sectors in UK real estate.

Quite simply, OPRE is where much of the action is.

However, underwriting operational investments presents additional challenges for lenders – as it does for investors and managers – and their perspectives and common areas of focus need to be considered.

Whichever model has been used to access OPRE, a high level of transparency is likely to be required by the lender in relation to the operators, occupiers, the business environment and trading conditions. Critically it means evaluating corporate risk alongside conventional real estate risk.

Appraising an asset second hand

While a lender may be at a lower risk attachment point, they are likely to require the same detailed degree of reporting as investors in order to evaluate risk.

For example, a lender has to rely on second hand information from both the owner and the occupier. This means less upside and little ability to influence the outcome of a deal.

Using the example of a new BTR scheme, lenders will need to be able to accurately assess the potential income and create a financing structure that works off that. However, that income is fragmented and, at the beginning, unproven.

This means there needs to be a better initial analysis of potential income – and its increases – not to mention the netting of operating expenditure, or the difference between gross and net income.

The fact many OPRE assets have more occupiers and shorter contracts adds to the challenge for lenders. A building leased to an investment grade tenant has a cash flow inherently less risky and simpler to analyse than one to multiple lettings. When underwriting an asset from the perspective of a lender that translates into more complication and work for the same rewards.

Analysing operational expenses in detail

Alongside the income profile are the costs incurred via the operator in this model such as energy, services, staffing, etc, which impact the bottom line and means margins and free cashflow can be impacted by changes in operating costs even if income remains unchanged.

In a conventional lease the tenant bears operational costs and the risks inherent in them. In OPRE investments – depending on how they are accessed – the owner is more exposed. This means having to take into account costs around staffing and operational expenditure, in addition to property expenditure. In practical terms it means a shift in who is carrying the risk of operational expenses from occupier to owner/operator and therefore lender if debt is serviced from free cashflow.

This all means that OPRE loans are reliant on potentially variable net operating income to service debt, rather than just a defined and contracted rental cash flow.

The hotel sector presents the clearest example, where leased hotels have tighter yields than those on franchise or management agreements, because there is a degree of insulation from variations in the operating cost.

A lender needs to be able to see and evaluate this to establish the cashflows available to service debt and support asset value which ultimately supports repayment, which is why OPRE calls for more transparency in performance, operations, and the wider business both on an ongoing basis and in the valuation process. The clarity from occupiers and owners about potential and actual trading is absolutely crucial and if done well, will support keen pricing of credit for the sector.

Of course, the onus is not all on occupiers and investors. Lenders will need to make sure they interpret all of this information correctly and not onerously, creating difficult and costly reporting requirements.

Valuing a corporate entity

What this greater understanding boils down to is being able to assess the viability and sustainability of corporate cashflows and current and future trading potential, thereby underwriting a business and not just a real estate asset with a lease in place.

The analysis has to focus on not only revenue but costs volatility, profitability and free cashflow, or the bottom line. Investors – whether debt or equity – have to look at both historic and projected trading, costs and consider metrics more traditionally associated with corporate rather than real estate analysis.

Lenders for non-OPRE assets have traditionally focused on LTVs – especially when interest rates were low. OPRE assets must take into account trading, costs, management teams, past and future performance and supply and demand factors alongside the real estate fundamentals and investor demand.

It's a broader approach and it means changing considerations on a cashflow and lending basis, analysing and underwriting variable factors which impact the ability to sell, refinance or repay loans from the underlying collateral cashflow and value.

From opportunistic to core

An OPRE asset may be at risk of greater volatility than a property with long FRI leases and this is reflected in pricing and often has led to investors requiring a wider yield or risk premium. This does not mean, however, that assets cannot be suitable for core or debt investors.

Key to winning over lenders will be understanding the potential volatility of cash flows presented by the operational business or leasing structures, enabling lenders to underwrite the same, and set debt service with a suitable headroom, provided they have the necessary past performance and future forecast information and therefore can appropriately price the risk.

Reporting, more information and education are all essential. In Europe there are shorter leases and more tenant churn, but it's accepted by lenders with a broad and diverse debt market.

The distinction between OPRE and non-OPRE may lessen as willingness grows to understand the true potential of assets to generate cashflows and therefore drive value.

The "hotelisation" of offices is already happening with the provision of more service to a higher level and the separation between owners and occupiers of real estate being steadily diminished, with tenants of office buildings requiring more amenity and services from owners.

In future, much of the opportunity for lenders will be in the alternative sectors. This will drive further acceptance and lenders will be unwilling to lose an opportunity to lend on assets that can be considered just as secure as core.

Key to successful OPRE lending will be ensuring adequate information for underwriting: looking at past performance and projections for revenue and bottom line income; the setting of sustainable cashflows for debt servicing; and using that cashflow to arrive at a sustainable exit value with which debt can be repaid from either through a sale or refinancing.

Where lenders enter: Risk exposure in conventional RE vs. OPRE

Conventional RE

Contracted rental income
Additional revenue
Gross rent
Net rent

Lender enters here
Uses full cashflow to establish sustainable debt service with acceptable headroom

Tenants covers:
Utilities
Refresh
Fit out
Capex
Etc.

OPRE

Income
Additional revenue
Gross rent
Net rent
Staff

Opex
Repairs
Marketing
Etc.

Lender enters here
Uses resulting cashflow to service debt based on acceptable headroom

Alternative lenders

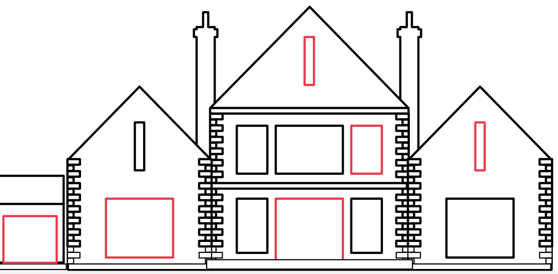
- Many insurers and credit fund lenders have the benefit of experience of OPRE, particularly in the living sector in the US.
- Tend to have a deeper understanding of the sector than "traditional" lenders.
- These lenders have the ability to hold large (£100m+) debt tickets without the need to syndicate. Benefit for sponsor in having and maintaining a relationship with that lender.
- Generally willing to be more flexible on operational terms whilst maintaining a degree of control via the business plan.
- Possibility of whole loans providing increased leverage on a senior facility.
- Fixed rate facilities available (exposure to underlying interest rate rises is therefore minimised).
- Pricing will be reflective of the increased risk and cost of capital, but possibility of step-downs following development phase and post-stabilisation.

7 The art of operations

In the context of OPRE investments, operators often sit in the demanding position between the end users of real estate and the managers making investment decisions on behalf of the investor.

"Operators often have to straddle both the customer facing and investment management worlds, which requires them to wear a number of different hats and demonstrate a broad range of skills" says Robert Porter, Senior Consultant at Macfarlanes.

"Alongside day-to-day asset management and considering how to optimise the investment, operators are also critical in supporting managers with their investor reporting, ESG compliance and generally in fulfilling their obligations to their investors."



Influences on operators

Customers

Investors/Managers

Asset management
- Financial reporting
- Asset reporting
- ESG reporting
- Fiduciary duty

Building management
- Technology
- Building safety
- Building intelligence

Resident management
- Technology – apps
- Service
- Accountancy

Source: Ringley Group

Adding value to management

Effective management means the efficient day to day running of operations. Are renewals strong and customers happy? Are maintenance and energy costs kept down? Whether for a cold storage operator or a co-living specialist, it's about keeping the business running smoothly.

Furthermore, it's up to operators – whether in house or third-party – to be able to effectively run services that add to value. These need to be managed and measured, both in terms of extra income, but also in terms of how they add to operational complexity and if they warrant their cost.

Mary-Anne Bowring, founder of Ringley Group, says it is possible to drive additional income outside of rent.

"By generating social value and raising the product to lifestyle, which extends beyond the building and into the community beyond," she explains.

This brings with it its own difficulties in terms of reporting and measurement, but also in implementation and management – which is where brand and technology can play a key role.

Financial and asset reporting: data and the role of technology

Technology is critical in operational strategies, both in providing a service to customers and in analysing the data needed by investors and managers for effective financial reporting.

Management software needs to see how much something costs, how much it is used and then how much it adds to, or takes off, the bottom line. This process needs to be seamless and compatible with other systems.

However, it can also be an expensive "add on". A key consideration is whether the technology really helps in terms of its price, and in how compatible that technology is. Can it be used with other software programs and can its outputs be effectively understood by investors?

Bowring points out that technology is only as good as the data that goes into it.

She has a checklist to de-risk operational technology that includes a compliance led approach with minimal user input that includes exception reporting and the ability to auto-schedule reports and trends analysis.

Brand and marketing

If technology permits effective management and analysis, at the other end of the spectrum it is brand and marketing that drive customers towards a business.

Effective branding inspires trust and confidence in a product, and, eventually, the potential to charge a premium, as in a hotel. An effective brand means a product will be sought out.

Realstar, when it started to invest in and manage UK BTR, created a new management company, UNCLE.

"The entire ethos behind our UNCLE brand stems from our experience in owning and operating hotels," says Ryan Prince, chairman at Realstar Group.

"Brands have been a huge driver of hotel success since the likes of Kemmons Wilson at Holiday Inn, Bill Marriott, Conrad Hilton and fellow Canadian Isadore Sharp (Four Seasons). Our view was that for some unknown reason, no one has developed a B2C (business to consumer) brand in rental housing and we decided it was time to change that."

Achieving this may help in making assets more appealing to the core market.

However, creating a brand is just the first hurdle. While it can command additional value if an asset is sold, expenditure needs to be quantified and justified, which can be more difficult than in a conventional RE asset. The efficient use of technology and data is essential in managing this.

> "You want an asset for which people are willing to pay a premium for a number of reasons. One reason is, as a core investor, I want my asset to let first in the market or be one of the first that lets. If you have ten assets vacant, you want the assets to be choice number one or choice number two for tenants.
>
> **Simone Pozzato**
> MD – HECF Fund Manager at Hines

Building a B2C business

Operations go further than branding and need to focus on working with customers, the ultimate users of the real estate. Investors taking on OPRE need to understand the B2C component.

This comes with its own risks and different operational priorities. Using the example of student accommodation, Pozzato says the skillset, energy and initiatives of the student housing manager on-site are crucial to improving renewal rates and in creating a safe and happy environment.

"At the end of the day, it's a B2C business" he says.

"Our success as a B2B is if investors are investing with us. If you operate a B2C you want the students to recommend their student housing to someone else, to their friends at university or someone else, or to renew, to continue to stay there for the following year."

This is an aspect of management that will feel unfamiliar to many real estate investors. Alongside the economics of the operations, brand, organisation and customer interaction need to be highly prioritised and run effectively. Otherwise, the bottom line will suffer. That's where the operator comes in.

IFRS 16: making tenant reporting regulations easier

It is not just investors that can benefit from the different treatment of operational structures. Tenants too can find advantages.

Following IFRS 16 implementation in 2019, tenants faced considerably more onerous accountancy requirements in regards to how to treat lease liability.

Changes to the rules meant lease liabilities/assets previously under operating leases were capitalised and put on the balance sheet with the present value of the lease payments visible. For example, if a tenant leases an office for 10 years for a rent of £100,000 per year, that means £1m on their books as a liability and their financial ratios consequently impacted.

Under OPRE, models tenants can use service contracts, rather than leases.

A service contract differs in that a lease transfers some control of an asset to the user. In a service contract the owner uses the asset to deliver the service while retaining full control.

For example, a cold storage user takes a service contract on a portion of a warehouse. An office tenant takes a fixed space in a serviced office.

While there may be higher annual service costs in a service contract when compared to a lease, from a tenant's perspective their balance sheet position may look healthier, which in turn may help their business.

A UK cold storage operational example: Sadel Group

Andrew Lawrence is a director at Sadel Group, which uses OPRE to help run its temperature controlled logistics assets.

Sadel bought into an operational cold storage business in Scunthorpe in 2011 after building up experience with previous ventures.

“From that experience, we realised that the most important part was having control of the operational arm of it. There’s a much larger opportunity than just the standard real estate lease,” says Lawrence.

Sadel invested money back into the assets, restarting the refrigeration, putting new racking in and redoing certain areas of cladding. From here the business started to develop a new format, which Sadel developed a platform around, by building up the old business, building acquisition and M&A.

Now the cold storage business is operated by Magnavale on a day-to-day business, while Sadel operates the asset management aspects and oversees operations.

“In a way that a hotel manager would be structured, it provides operational management services to the structure that owns the facilities. Structuring in this way provides optionality from both a debt and equity perspective” says Robert Porter, Senior Consultant at Macfarlanes.

The key was moving away from a family orientated business mindset to an “almost private equity way of operating,” says Lawrence.

“No-one had looked at it in an entrepreneurial way of realising what you could do with the business and running it how you would run a real estate company with proper asset management,” he says.

Income has been grown in a number of ways.

Sadel immediately switched to looking at its real estate from sq ft to cubic volume storage, as produce is stored on pallets. This allowed internal area to be maximised, for example, a 100,000 sq ft building with a height of 50 metres sees its capacity drastically increased.

The charging structure was also changed. All pallets coming to the facility receive a Receipt, Handling and Dispatch, or “RH&D” fee. The storage fee itself is in addition to this. The more pallets the facility processes the more RH&D fees it generates.

Further services are then offered – blast freezing, microwaving (from -20 to 0 degrees Celcius), repacking and date coding.

“Effectively, we try and smooth out a customer’s supply chain and offer more under one roof, reducing food miles and increasing food security,” says Lawrence.

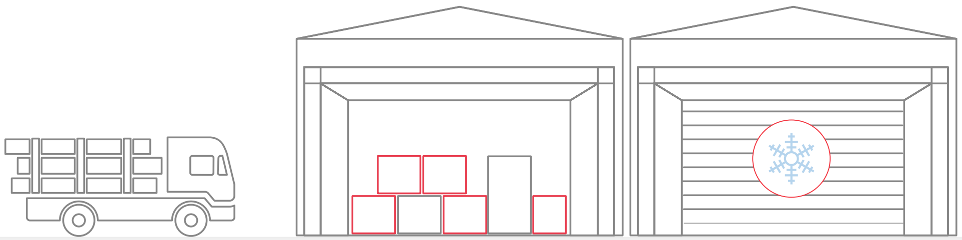
Critical has been the ability to service customers through the operational structure created and the brand created above that, which gives customers confidence.

“This is probably the difference between standard real estate, where you’re a conventional landlord, and operational real estate, where today we have 95 different customers storing 46,000 pallets (at one site). Service to those individual customers is absolutely paramount,” says Lawrence.

A lot is tied in with food security and reliability of delivery, and it is in this context that branding and confidence in an operator is of paramount importance.

> “Core to our brand purpose is addressing the current challenges around food security, food mileage and sustainability. Our customers know that we are going to deliver their food on time, in full and in excellent condition.
>
> **Andrew Lawrence**
> Director, Sadel Group

The market is set to expand as explored in section 9 of the report, but the difficulty for capital trying to enter the market has been in explaining the additional operational elements of the sector, moving beyond a one tenant business to an operational business based on real estate.



The operator's perspective: Charlie Gayner, Co-founder of re:shape and ARK

"re:shape specialises in PBSA, Co-living and Hybrid Hospitality. It currently has a 300-bed co-living scheme in Wembley which opened six months ago, with a strong future pipeline.

It's no secret, given current market challenges, the industry is having to be more proactive about asset management. While it may be different to what has gone before, it's not something to be afraid of.

We're very hands-on with the operational element and work closely with our operational partners and teams on the ground.

Typically we act as a "sponsor" or management team with private equity and work closely with funding partners to ensure their assets provide the best possible customer experience whilst maximising NOI. This is particularly the case with co-living, where the sector is still emerging and few have experience in operating such assets.

For me, there are a few important aspects that stand out that help us stay close to the detail of our investments and ensure clarity for our investors.

Effectively using third-party management

Unless you have scale of over 1,500 beds it's challenging to achieve the economies of scale needed for your operations to be more cost effective than outsourcing.

Currently, we outsource day-to-day asset level operations to third-party managers, who provide a white label service under the brands we create. re:shape acts as the asset manager to ensure the business plan is being met and a high quality customer experience is being delivered in line with our brand standards.

The disadvantages are that you're reliant on third-party managers who aren't focused exclusively on your building and brand.

Our role is therefore to hold everyone accountable to high standards with a focus on our buildings. We spend a lot of time in our financial reporting to sense check NOI and ensure our investors are up to speed on performance.

Ensuring brand standards

An effective way to differentiate and achieve strong demand is through branding.

We create comprehensive brand standards for our project teams to follow, which lay out in detail what our values are and what we want the experience to be, from ensuring how our onsite team interacts with customers to the technology used to manage memberships.

Where this doesn't always match up with the standard operating procedures for the third-party operations manager, this sometimes means that these elements need to be internalised so you have greater control in areas which allow you to differentiate your offering.

Effectively using technology

Technology is a further key focus to permit effective management and customer experience, though it's often a real headache as there's no one-size-fits-all technology that works across the customer journey.

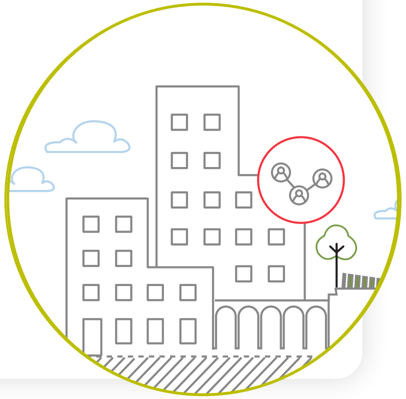
At our Wembley ARK scheme, which is an innovative co-living concept allowing someone to stay from 1 night up to 12 months, we have to use a hybrid of different systems from BTR and hotel software which means that often you're working in silos as opposed to having a joined up single piece of software.

Having a single co-living software PMS would solve reporting challenges in regards to reconciling revenue and operations costs, in addition to having clarity on demographics.

Equally important, our target market is millennials and Gen Z who are digital natives and expect a level of service and technology within our buildings. Being able to book a studio instantly and have a customer app which deals with maintenance issues and notifies you of a parcel delivery has been a big focus for our operations.

So technology is an important focus and an area we'd like to invest in to ensure we have the best offering in the market.

In the end it's another way of ensuring that we stay close to the detail so that our investors have full visibility on performance and we receive direct customer feedback to continue improving on the product and experience.



8 Answering OPRE's big questions around tax, governance and structuring

The notion of becoming comfortable with "operational risk" in reality means becoming comfortable with a plethora of risks and considerations not generally present in a conventional real estate investment model.

Effectively evaluating and addressing such risks may demand that investors and managers acquire new skillsets, adapt existing investment processes and work with different service providers.

In this section we provide an overview of some of the unique considerations and challenges presented by investments in OPRE and how they can be addressed.

Tax

From a tax perspective, there are two key questions when investing in OPRE: how will income be taxed during the life of the investment; and how will gains be taxed on exit?

Income during hold period

Real estate income can be "investment income" or "trading income", depending on the type of investment.

The distinction between the two is highly fact specific but, for example, rent from a conventionally leased office would likely be considered investment income, whereas income from a hotel operating business would be trading. OPRE will normally fall within the latter category.

For certain classes of investor, it's important that income received is, as far as possible, classified as investment income rather than trading income. These include:

- UK pension funds – as they are only exempt from tax on their investment income;
- REITs – as REIT rules require at least 75% of a REIT's profits must come from investment income rather than trading income; and
- certain types of German investor – as German rules mean they may not wish to receive trading income.

If these investors wish to invest in OPRE-style assets tax efficiently, they need to consider whether to let the OPRE asset to a third-party operating company on a conventional lease. This means the rental income would then likely be considered investment income.

Gains on exit

The basic position for investors holding UK real estate is that any gain will be subject to UK tax – at 25% for companies – on exit.

This is the case whether the UK real estate is sold directly or whether the entity holding the real estate is sold. It is also generally the position even if that entity is non-UK resident, as most of the UK's double tax treaties with other jurisdictions give the UK primary taxation rights on the sale of non-UK resident entities that are UK property rich.

Substantial shareholding exemption (SSE)

As Propcos holding OPRE are often trading companies, it may be possible to benefit from the UK SSE. Where this applies, any gain made on the disposal of shares is exempt from UK tax.

The two key requirements are, broadly:

1. the substantial shareholding requirement: the seller must have held at least 10% of the shares in the company for a 12-month period starting no more than six years prior to the disposal; and
2. the trading requirement: the company being sold must be a trading company or the holding company of a trading group or subgroup.

The illustrations on the next page show how OPRE can benefit from the SSE on exit.

UK/Luxembourg double tax treaty

The UK and Luxembourg have recently ratified a new treaty which permits the UK to tax gains made on the sale of Luxembourg entities holding UK real estate. These new rules take effect in the early part of 2024.

QII SSE

Even if a Propco isn't trading, it may still be possible to benefit from the SSE. Where certain types of investors, known as Qualifying Institutional Investors (QIIs) such as pension schemes, sovereign immune investors and charities own 80% or more of the shares in a company (Company A), the whole of the gain Company A realises on the sale of shares in another company (Company B) is exempt from UK corporation tax. This is the case even if Company B does not meet the trading requirement, provided the substantial shareholding requirement is met. If QIIs own at least 25% but less than 80% of shares in Company A, a corresponding proportion of gain will be exempt.

Establish an operating company (Opco):

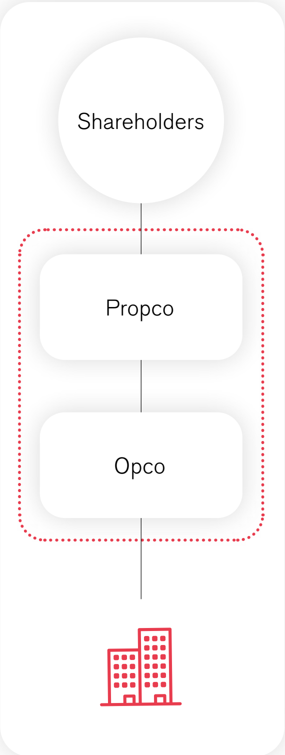
Current: Propco owns the freehold of a hotel and leases it to a third-party operator which runs the hotel. A disposal of Propco would be subject to UK tax.

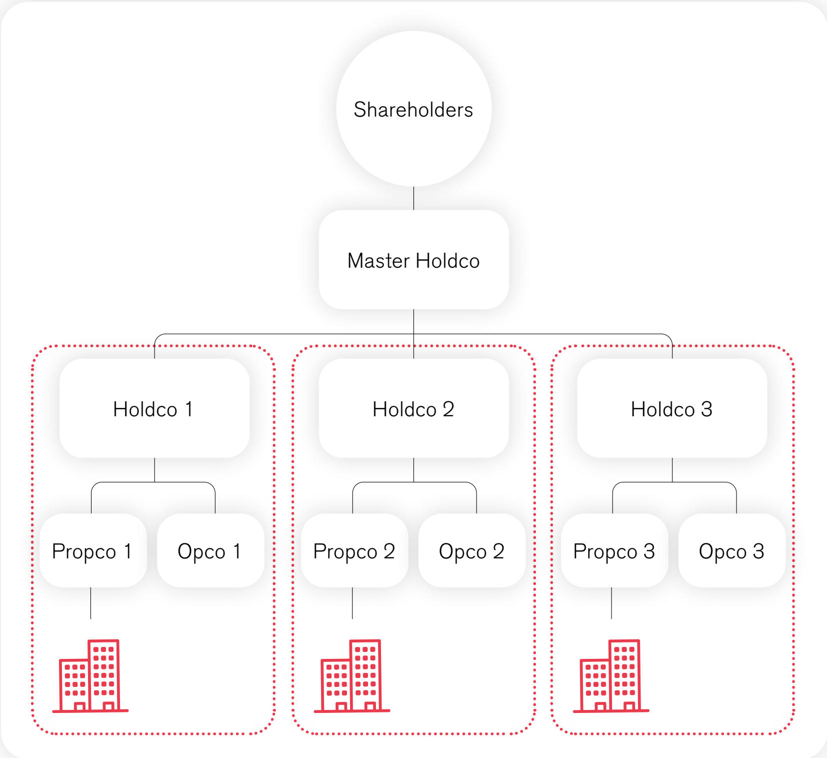
Alternative: Establish an Opco, as a subsidiary of Propco, which contracts with the operator to run the hotel as manager or agent. Disposal of Propco could benefit from the SSE as Propco-Opco forms a trading subgroup.

Establish a trading subgroup:

Current: Master Holdco is the holding company of a trading group. Each property is held in a separate Propco. Operations for all the properties are housed in a single Opco. Any disposal by Holdco of a Propco would be subject to UK tax.

Alternative: Establish separate Holdcos and Opcos for each property, with Propco and Opco as subsidiaries of the same Holdco. Any disposal by Master Holdco of a Holdco should benefit from the SSE.





REITs: sale and holding strategies

Structuring OPRE investments so investment income and trading income go to separate entities – e.g. a Propco holding the property and an Opco running the business – also makes sale to a REIT possible, as a REIT is able to buy only the Propco. This is desirable because to comply with the regulations REITs will want to receive investment income rather than trading income.

Under this structure it is also possible to hold assets in REIT structures.

Scenario	Is it possible to use a REIT?	Tax treatment
Group owns both the Propco and the Opco	No	Hold period: 25% corporation tax. Payable on all Propco's rental income profits, although tax relief (known as capital allowances) is available on qualifying capital expenditure. If Opco is UK tax resident, UK corporation tax is payable on profits but deductions should be available for rent paid to Propco. Exit: no tax on gains on exit. As long as the SSE or QII SSE is available (see above), any gain made on the sale of Propco/Opco should not be subject to UK tax.
Group owns the Propco and a third-party owns the Opco	Yes, if all the other REIT conditions are also met	All distributions (both of income during hold period and of gains on sale of Propco) subject to 20% withholding tax, reduced to 15% under some double tax treaties and to 0% for certain exempt recipients.

OPRE and social value: Dan Marriott, Partner at Macfarlanes

“The real estate industry, as creators and custodians of the built environment in which we all live and work, has always had a significant role in the generation of social capital.

In recent years environmental – and increasingly social – considerations have become integrated into the decision making process to provide real asset solutions to societal issues.

The growing focus on social impact – defined by the intention to create social good through clear social as well as financial return objectives – is particularly well suited to the end user focus of OPRE strategies.

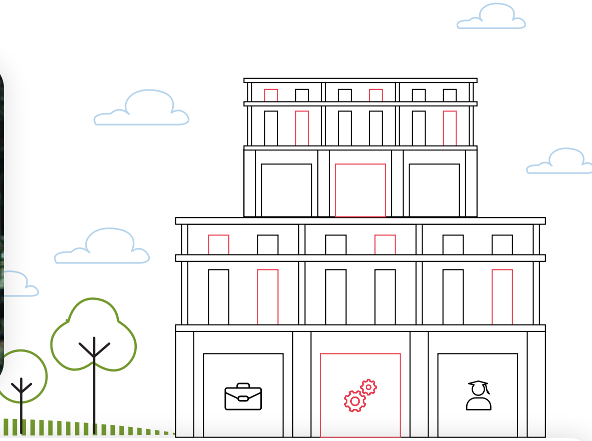
In particular, the operational living sectors, as well as healthcare and other forms of social infrastructure, present numerous opportunities to promote the wellbeing of both occupants and the broader community and provide opportunities for underserved communities. Examples include the curation of community programmes to provide services or meet specific needs, such as wraparound childcare, activities to promote community cohesion or education programmes to promote financial literacy or employable skills.

As the ULI said in its 2022 Social Impact paper, “there is a growing emphasis on more operational forms of real estate and risk management as a means of driving returns and managing risk. In this regard, “intentionality” and “additionality” are not new concepts, rather it is often the prospective audience that is new”.

As with the broader OPRE market, in many cases, investors and managers will need to partner with specialist operators and advisers to implement social impact strategies. This is especially true in the context of understanding the specific needs of underserved communities.

Critical will also be the carrying out of appropriate due diligence on any third-party operator from a financial, performance, governance and regulatory perspective, as well as in relation to key personnel.

Being confident in the selection of an operating partner and having strong alignment and transparency in operations will be essential to ensure the success of the venture and effectively manage risk, particularly in sectors with reputational risk.



Reputational Risk

The reputational, and sometimes regulatory, risk that comes with bringing investors closer to the “end user” of real estate, particularly where the asset is serving vulnerable groups, is an often-cited difficulty in OPRE investments. Many investors are simply unfamiliar with addressing the needs of such end users and feel ill equipped to assess and manage the risks entailed.

Selecting the right operating partner is critical to managing this risk and several investors have employed sector specialists and former operational professionals to help in the selection and oversight of their operating partners.

Integrated into investment teams and governance, such individuals can help better assess the performance of the operator on the ground and spot any “red flags”. They can also help evaluate key performance metrics and reporting, and in some instances hold a seat on the board of the operating business itself.

As with any third-party service provider, conducting thorough due diligence of an operational partner is crucial. This can include an assessment of financial health, performance track record, anti-bribery and corruption and regulatory compliance, alongside testing the rigour of governance, policies and procedures and the background of key personnel.

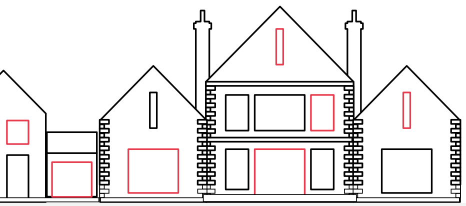
Additionally, a strong alignment of interests through incentivisation structures will help develop well-functioning service provider relationships. This could include a performance element to the operator’s compensation or fees for attaining certain milestones in the investment lifecycle. In some instances it may entitle the operator to participate in the carried interest scheme alongside the manager.

Valuations

Traditional real estate valuation methodologies do not necessarily capture the additional value associated with the operational component of the asset. How should additional income, corporate structure, human and intellectual capital be treated, and does that fit into a total return? This is as important for lenders as investors.

Valuation considerations may also impact fee arrangements, where fees are calculated by reference to investment or fund value. Longer term, if there is value created in the operational entities through brand, how should models incorporate, or at least start to think about this?

At the present time, there is a significant amount of divergence in practice across the market and no industry standard methodology. This means defining rules at the beginning of any contractual agreement.



Net present value valuation – a solution?

The Investment Property Forum (IPF) says the net present value approach offers a "conceptually sound" way of valuing OPRE.

Building on a discounted cash flow model, an investor determines the present value of expected future cash flows using a required rate of return.

However, it acknowledges this is less popular than the use of IRRs, which are quicker and easier to compare with other asset classes. It also says there are issues with the analysis of variable cash flows, poor financial modelling, and a reliance on modified discounted cash flow model.

The IPF made several recommendations for a more effective valuation system for OPRE.

1. Separating the risks of physical assets from the operator (and their ability to generate cash flow) during the appraisal process.
2. Better data sources and analysis to underwrite operator performance – with a "forensic" examination of revenues, costs and profits and the market sub-sector.
3. Using the net present value approach but with a comprehensible modified discount rate that reflects traditional property and operator risks, business risks and the creditworthiness of an operator.

Conflict management

OPRE investment structures can pose particular challenges when the interests of investors, managers and operators strongly diverge. The risk of conflicts arising is particularly acute in a scenario where the manager has created a "vertically integrated" platform and also owns the operator.

In this context, investment managers must be mindful of both their fiduciary duties owned to investors and applicable regulatory requirements related to conflict identification and management. For example, the European Alternative Investment Fund Managers Directive (AIFMD) imposes an obligation upon alternative investment fund managers to maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps designed to identify, prevent, manage and monitor conflicts of interest in order to prevent them from adversely affecting the interests of the fund and their investors. In a JV context, while not generally within scope of AIFMD, a manager may still be subject to the overriding duty to manage conflicts fairly set out in COB 7.1 (Conflict of interest and material interest) of the FCA Handbook. Additionally, the contractual terms of any fund or investment mandate may set out further frameworks for how such conflict scenarios will be approached.

Examples of scenarios which may give rise to conflicts within a vertically integrated investment management business and potential tools for managing such conflicts are set out below.

Conflict scenarios		Management tools
Terms and fees	• The manager appoints an affiliated operator to provide services to the fund or investment mandate.	Terms and fees are clearly set out from outset of engagement, inflation linked increases.
Exit	• At end of the fund or mandate life, the manager is liquidating the fund assets on behalf of its investors, but will continue to own the operator. • The operator may be engaged on an ongoing basis to provide services to the assets under new ownership.	Defined processes and timescales, independent valuation, separate representation of interests of manager and investors, third party bid process, fairness opinion.
Termination	• Investors wish to terminate the appointment of the operator for cause.	Dispute resolution and for cause termination provisions, manager excluded from vote.
Oversight and accountability	• The manager owns the operator but also is responsible for the oversight of services providing to the fund/mandate.	Fund advisory committee, dispute resolution mechanisms, independent directors, reporting and KPIs.
Competing commitments	• The operator does not provide services to the fund/mandate on an exclusive basis.	Disclosure, key man provisions, restrictive covenants.

Effective investor engagement and appropriate disclosure

Exit strategy

A key moment in the OPRE investment lifecycle where conflicts are often triggered is during sale. If much of the value of real estate asset is derived from its effective operations, the extent the operator is "tied" to the underlying real estate becomes key in achieving a successful exit from an investment.

Owner operators

Where the operating business and real estate have common ownership and are being disposed of "as a whole" there are no divergent interests. Conversely, there can be a reduced pool of buyers who want to take on the corporate exposure as well as the real estate.

Management agreements

Where the investment uses a third-party service provider via an operational management agreement, there are fewer opportunities for interests to diverge. But to achieve a successful exit, investors and managers need to be mindful of the duration of such agreements and ensure it can survive an exit. Provisions allowing the operator to terminate the agreement in a change of control scenario may not be appropriate and the size of the pool of substitute operators needs to be considered.

Hybrid structures

Structural scenarios where the manager owns the operator and the investor owns the real estate present the greatest risk for conflicts of interest. The investor may need continued involvement and cooperation from the operator in order to achieve the best exit value. Meanwhile, the manager's interests might be best served by providing operational services to another vehicle or investor.

Further risk considerations

1. Investor risk

Oversight and reporting

Issue

How does the investor achieve the requisite level of visibility and oversight of the operational business?

Approach

Varies according to method of accessing OPRE. Can range from reporting and a rigorous annual budgeting exercise, or in a JV or platform context, board representation and specific control rights. Well-defined KPIs and performance related compensation can incentivise behaviour.

Reputational risk

Issue

OPRE sectors can concern emotive topics, particularly where they are aimed at serving more vulnerable members of society, such as the sick or elderly. As a result, such assets entail a greater risk of incidents occurring that can cause reputational damage.

Approach

Rigorous operator selection and due diligence, in addition to ongoing oversight (explored above). Operators may also be structurally distanced, to a degree, through fund investments and the use of operational management agreements with appropriate termination rights for bad behaviour.

Governance and restrictive covenants

Issue

Ensuring there is an appropriate level of "linkage" between the real estate asset and operator, particularly in nascent operational sectors where there is a small pool of substitute operators.

Approach

Key person provisions and appropriate notice periods in a termination scenario. Use of non-compete and radius restrictions to prevent competing operations in vicinity of assets. Exclusivity over operator pipeline.

2. Sector risk

Policy and change of law risk

Issue

Operational sectors and in particular the living sectors are presently experiencing high levels of policy and change of law risk, with numerous intitiatives focused on the rental sector in particular. A potential change of Government in the UK at the next election further exacerbates this risk.

Approach

Tracking of policy developments and engagement with industry bodies. Change of law risk to be incorporated into investment due diligence process and subject to ongoing monitoring.

Sector specific operator regulation

Issue

Certain areas of social/affordable and senior living are subject to regulatory oversight by the Regulator of Social Housing and Care Quality Commission. This brings compliance burdens and ongoing oversight and reporting alongside reputational risk.

Approach

Detailed pre-research and knowledge of regulatory and compliance burdens. Rigorous operator due diligence and ongoing oversight. Pricing of risk into operational models.

3. Operator risk

Intellectual property

Issue

Ownership and right to use IP associated with the operation of the real estate (e.g. booking facilities, occupier interface apps, or brand names) can be a particular concern, particularly if an investor and operator part ways.

Approach

Parties to appropriately map required IP and put in place the correct licences for use from outset. Consider what IP will still be required should operator and investor part ways and attempt to contractually define from outset.

Employee related considerations

Issue

If OPRE is being accessed by way of JV or platform investment, employees may be brought within the investor's ownership structure. For many real estate investors this presents a new category of risk.

Approach

Clearly identify where in the ownership structure employees and therefore employee related risks sit, such as pension liability considerations, dismissal claims, discrimination and harassment claims. Ensure that appropriate oversight and policies are in place for effective management of risks and that key individuals are appropriately incentivised.

Data and privacy considerations

Issue

Investor may be exposed to larger volumes of end user data and associated data protection requirements.

Approach

Where data is being collected, establish contractually who is the owner of that data and the legal requirements for its management and privacy (for instance in relation to GDPR). Explore advantages of data collection and its use in providing better service and for informing strategy and reporting.

9

Future OPRE opportunities

An aging population

It's a well-known fact that the UK's population is getting older. According to data from the Office for National Statistics, there are currently 12.3 million people over 65 in the UK. By 2043 this is projected to grow to 17.4 million.

Amongst other things, this aging population will need suitable places to live with adaptable levels of care. Savills estimates the country could accommodate over 300,000 more senior homes.

It's the ultimate demographic driver for an asset class. Additionally, senior-orientated residential products reduce hefty Government care bills and free up existing housing supply, thus reducing the housing crisis. This means a huge level of support for the right products. Crucially, due to the sensitivity and complexity of elderly care, they need to be effectively operated.

1. Rental senior living

In comparison to the for-sale senior sector, there has been less focus on the rental market. However, this is now starting to change, with the likes of M&G investing with Birchgrove and L&G through Inspired.

It has proven to be challenging in terms of winning over existing home-owners, but the sector offers advantages in terms of flexibility for residents if their situation changes, all in one charges and the avoidance of maintenance.

From an operational perspective – if the financial modelling and level of management can be worked out – it gives an excellent chance to tap into longer term income streams while providing a valuable and increasingly in demand service.

It also means a variety of models with varying degrees of management and changeable levels of support and services.

2. Care and nursing homes

The progression from independent senior living is care homes, where a higher level of care is provided for residents who can no longer live by themselves.

The sector is no stranger to private investment but underwent problems post-2008 when cash-strapped councils could no longer refer tenants. However, it's still a sector that will be hugely in demand going forwards and increasingly important to avoid bed-blocking in hospitals.

Savills research says the number of beds has gone down as a proportion of over 65s in the UK. This means the sector will be crying out for effective private sector investment and management going forwards.

3. Integrated retirement communities (IRCs)

IRCs are the natural progression of the sector, merging senior "light" rental housing with care homes and other later living facilities.

As residents are renting they can move smoothly through the different levels, with no need to be uprooted from their community as they age and need additional help. Couples with different needs can also be kept together.

There's an array of possibilities with what to offer, from illness specific settings such as dementia villages, to a focus on wellness. Operationally, there is the chance for brands to grow that can help people transition between each stage of senior care.

4. Healthcare hubs

Thinking even bigger, a really interesting possibility is in the provision of large scale healthcare hubs providing all of the residential classes mentioned above alongside commercial and recreational spaces and medical facilities like GP clinics and testing labs.

Placed near to town centres the advantages are obvious for residents and permit a higher quality of life and access to care while easing the pressure on existing health services.

In the US the idea of healthcare hubs is often around medical innovation and there's no reason why this could not be included, with teaching hospitals and medical research positioned next to those who will benefit most from the care.

Running this through one operator would be a huge investment but could lead to a holistically and professionally manged product that could be run as a long-term hold investment.

Food

If an ageing population is a certainty, so too is one that will want to eat.

But as our palates become more sophisticated, supply is more complicated, with increasing demand for ethically sourced natural goods grown as locally as possible.

Shortages caused by Covid-19 and Brexit exposed holes in the UK's supply chain and food security, which means more demand for assets that can both store and supply food. As such, sectors focusing on food provision in the UK could see incredible growth going forwards.

1. Vertical farming and agriculture

It may seem from the realms of science fiction, but vertical farming is already well underway. Growing Underground has an urban farm 33 metres below Clapham and uses completely renewable electricity to grow its hundreds of products. Chinese company Sananbio makes vertical farms that function in self-sufficient shipping containers.

Harvest London, in a slightly more conventional model, operates two large logistics style sheds fitted out internally and provides over a hundred different types of produce.

The UK grows around 50% of its own food according to Government and vertical farms present a way of increasing its output, making up for both the lack of agricultural space and by providing 365 day growing seasons.

Renewable energy can be used to provide light, while there are efficiencies in the amount of water used and the run-off from pesticides. Critically, it addresses labour shortages through automation and relying on only a few highly specialised employees.

2. Cold storage

We cannot grow all our food, which means being able to store it effectively and efficiently is going to become increasingly important, to reduce waste and ensure supply, but also to meet sustainability targets.

Sadel have already explained how the cold storage model works (page 19), but the demand behind that is eye watering.

Changes to online shopping habits, better thinking around sustainble supply routes and increased food security in the wake of a supply crisis all mean the cold storage market is becoming increasingly complex.

The UK market is already at capacity, and with much older stock no longer fit for purpose it means a huge demand for new space.

While buildings can be standardised they need operational knowledge to run them efficiently, which means the market will take time to grow, while creating the right stock can also be delayed by the UK planning system.

3. Food hubs

As with senior living, what this could lead to is the emergence of food hubs, where everything involved in the growing, preparation and delivery of food is under one roof (or at least in the same park).

This saves on costs for transportation and storage and permits greater efficiency in the general provision of food. By making it more centralised it means better transparency and management and a prolonged shelf life of food.

The complexities of managing such centres will be great, but so too will be the demand.

Is it too much to think this could be at the centre of a waterfront regeneration project? Could abandoned docks be repurposed to take and store food from abroad while growing racks of salads in wharf side space, then processing and distributing that around the UK?

Life sciences

In the UK life sciences have grown up organically around the hubs of Oxford and Cambridge. That growth has been exceptional and the UK is one of the world leaders in terms of R&D and innovation.

The Government has announced various intentions to build on that growth and to do this, the sector needs to be able to perform more clinical research, have greater agility in its trials, better therapies manufacturing facilities and access to innovative medicines. This needs to be monitored and run though better data and AI.

In the US, professionally managed life science hubs are already popular and there is huge potential to bring a more large-scale model to the UK.

For schemes to work they need access to talent, educational institutions and business, providing lab and innovation space in equal measure.

The potential for professionally managed and orchestrated space and schemes is huge and already new models are emerging. At London's Canary Wharf an entire tower has been given over to life sciences in a JV between Canary Wharf Group and Kadans. Down the road at Surrey Quays, British Land and AustralianSuper have proposed a 300,000 sq ft life sciences offering within the Canada Water masterplan.

Retail and offices

It was stated at the outset of this report that all real estate, to an extent, has the potential to become operational. As such it's a fitting conclusion to look briefly at how offices and shops could be the next operational markets.

Retail

The best shopping centres (and retail parks) already add value by improving the customer experience, which in turn drives up rents.

There is nothing to stop these models taking on more upside from less passive, operational arrangements, adding on additional services, e-commerce options, events and management to increase income and values through shorter lease structures that profit from upside potential.

This could be important in the already streamlined retail landscape, and would also work out in a retailers' favour, with shorter-term contracts helping them in terms of commitments and liabilities.

This could go even further. Could struggling high streets benefit from a private sector town centre manager – an operational company paid a fee by each occupier – to holistically help run a struggling area in disparate ownership? This could sit alongside council resources, planning events and initiatives while promoting cohesion and cooperation between shopkeepers and landlords.

Offices

There is already a shift towards operational offices through serviced and co-working spaces. That is not the end of the affair, and operational principles can be applied to any office building to improve tenant retention and income. This in turn can protect values in a period of substantial upheaval in the sector.

A hypothetical prime central office building of 10 storeys and with a different tenant on each floor could offer an effective in-house managerial service that provides cleaning, restaurant, fitness, light medical and well-being services.

And the services need not stop there. It could be accompanied by different types of lease contracts that remove maintenance issues for tenants and provide greater flexibility as their needs and business change.

Brands could be associated with a certain level of product and service, so occupiers expanding into other cities would automatically hunt out offices they associate with a business friendly and stress-free product.

As office occupiers work to encourage people back into the workplace and take more flexible space, operational components could be what is needed to help the struggling sector evolve.

If you would like to discuss how any of the matters raised in this report apply to your business, please don't hesitate to get in touch with any member of the Macfarlanes team.

10 Contacts

Andrew Hughes
Private Equity Real Estate
View profile

Robert Porter
Private Equity Real Estate
View profile

Dan Marriott
Private Equity Real Estate
View profile

Justin Hope
Private Equity Real Estate
View profile

William Hedges
Commercial Contracts
View profile

Shailen Patel
Corporate Advisory
View profile

Jat Bains
Finance
View profile

Laura Bretherton
Finance
View profile

Harriet Miller
Private Funds
View profile

Nick Barnes
Real Estate
View profile

James McCredie
Tax and Reward
View profile

Rebecca Rose
Tax and Reward
View profile

Sarah Shucksmith
Tax and Reward
View profile

Tim Redman
Corporate and M&A
View profile

Fiona Beattie
Antitrust and Procurement
View profile

MACFARLANES

Macfarlanes LLP | 20 Cursitor Street London EC4A 1LT

T +44 (0)20 7831 9222 | F +44 (0)20 7831 9607 | DX 138 Chancery Lane | macfarlanes.com