IPF RESEARCH

At A Glance
FEBRUARY 2021

OPERATIONAL REAL ESTATE: RISK & REWARD

DIFFERENTIATING ORE FROM TRADITIONAL REAL ESTATE

ORE assets are NOT "alternative" real estate

Any asst could be deemed operational in nature during its investment lifecycle

Returns are directly and deliberately linked to the revenues & profits of the business conducted on or from the premises

INVESTOR MODELS & TYPES

Hybrid Lease
Vary in structure but linked to underlying business & focused on revenue/profit

Franchise
Know-how, procedures, IP & brand(s) licensed to franchisee

Management Contract
Third party operated the asset on for the investor + investor carries the risk

Owner operator
Fully integrated model whereby the owner operates their own asset

DIVERGENCE BETWEEN THEORY & PRACTICE

- Too little analysis of cashflow variability
- Over-reliance on modifying a 'traditional' discount rate
- Insufficient emphasis on NPV as preferred method of appraisal
- Inappropriate use of concept/ terms 'tenant', 'tenancy' & 'rent'
- Financial modelling skills lacking or poorly utilised

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Key Findings

- Investor demand for ORE assets has risen dramatically over the last decade.
- Many attributes that are important to assessing risk in ORE may be unfamiliar to real estate professionals, for example understanding the key components of corporate accounts relevant to a property owner's investment. Uncertainty and inconsistency in this area may affect the liquidity of such assets and, therefore, price transparency.
- There is no standard approach to assessing ORE within the real estate investment industry.
- Gaps exist between the theory and practice of assessing and quantifying risk, especially the under-analysis of the variability of cash flows and in the calculation and application of discount rates.
- The gap analysis does not suggest the requisite skills do not exist in an organisation, but questions whether those skills are being utilised efficiently.

Recommendations

- Separate risks associated with the physical asset from those attached to the skill of the operator.
- Use equity skill sets to examine the tenant/operator's revenues, costs and profits.
- Seek out data sources outside the traditional real estate market.
- Use Net Present Value approach to appraise opportunities.
- Build a comprehensive discount rate.
- Broaden skill base and financial knowledge; use risk modelling from other asset classes.

The full and summary reports may be downloaded from the **IPF website**.

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