

## Insights

# OPERATIONAL REAL ESTATE

## CHALLENGES AND OPPORTUNITIES

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### A DISTINCT ASSET CLASS?

Operational real estate is often spoken about as if it is a distinct real estate type or as if the term is only applicable to certain more operationally intensive real estate types such as hotels or care homes. Whilst the latter has been the case historically, all real estate has become to a greater or lesser extent more operationally intensive and more focussed on occupational needs as a result of a change in tenant requirements and in order to drive income, the sustainability of income and the return on investment. In addition to the ubiquitous presence of service and amenity led flex office options, even owners of a more traditional office building need to create and maintain a product that caters for increasingly shorter tenancies, provides a more wide-ranging experience for its occupiers and more extensive amenities with a low carbon footprint. Similarly, shopping centres have metamorphosed into leisure centres focusing on 'experiences' to attract footfall, avoid obsolescence and generate new income streams.

### KEY DIFFERENTIATOR

Although certain asset types lend themselves to the operational real estate model, what distinguishes operational real estate from traditional real estate is not the property type but an operating model where the return to investors derives to a greater or lesser extent from the trading performance of an underlying operational business conducted on or from the premises as distinct from (or in addition to) a fixed rent and other typical ancillary income streams under a traditional lease. With less predictable revenue, the risks for an investor increase but so do the opportunities for those investors who are able to manage those risks appropriately.

### INVESTMENT APPROACH

There are a number of ways in which the approach to investments in operational real estate opportunities differs from the traditional real estate investment approach. Some examples follow below. Seasoned real estate industry participants with vast experience of traditional real estate investment strategies may be less familiar with some of the structures, nuances, precedents and

practices designed to address the opportunities and challenges posed by the operational real estate model. In addition, they may lack the operational and financial modelling experience and skills in-house (as well as the breadth of workforce needed) to appraise, quantify and manage the risks and optimise the opportunities of operational real estate.

## DUE DILIGENCE

In a traditional real estate deal the focus of due diligence is on all aspects concerning the real estate (including anything which may affect the ability to sell, let or otherwise dispose of the assets), any underlying leases and the covenant strength of the tenants. Operational real estate investments comprise a blend of real estate and business investment requiring careful analysis and understanding of a wider range of other issues such as the quality and performance of the operator (in particular its employees), the robustness of the operator's business plan, market analysis and sectoral trends and cyclicalities, financial projections, variability of cashflows, regulatory considerations and brand and reputational risks.

## COMMERCIAL MODEL

There is a wide range of possible commercial arrangements through which investors participate in the trading performance of the underlying business conducted on or from the real estate, each with its own characteristics, risk profile and potential returns. These include lease agreements with turnover rents or other variable rent components, performance leases, revenue or profit share agreements, joint ventures, equity participation or management agreements with incentive fees. These arrangements can be complex and require careful negotiation and management to ensure that interests remain aligned over time and that any exit strategy is not undermined.

## STRUCTURE

There are many different ways to structure operational real estate investments. Ownership of the real estate and operation of the related business may be integrated or there may be a separate operator that leases the real estate or manages it under a long term management agreement. Similarly, management of the operational business may be in-house or may be contracted on arms' length terms by the real estate owner. The choice of structure will largely be commercially driven but careful thought will need to be given to tax and exit considerations.

A common structure involves a financial investor partnering with an operator who has specialist knowledge and experience of managing the type of operational real estate involved and has the right resources. The financial partner may only be interested in the real estate or may also want to participate in the operational business. The joint venture or partnership agreement and/or management agreement will deal with profit sharing, operational roles and exit strategy.

## MANAGEMENT ALIGNMENT

Income and longer term sustainability will be driven by performance of the operational team. Whether they are in-house or contracted, incentives need to be aligned with short and long term investor interests and returns. Consideration will also need to be given to leaver provisions and non-competes and other restrictive covenants designed to protect the goodwill of the operational business.

## GOVERNANCE

Depending on whether or not the operational team is in-house or outsourced, investors will typically require rights and protections designed to enable them to monitor and measure performance, define the required service standards in a dynamic and competitive environment, set financial performance targets and hold the management team to account.

## CONCLUSION

Operational real estate is a people business. Investor returns are more dependent on the skills of a captive or independent operator rather than just the quality of the real estate. Investors and lenders will need to get comfortable with the management team of the operational business as well as the operator's business plan and will need expert advice on how best to structure operational real estate investments and management incentive plans. Investing in operational real estate comes with a wider range of risks but smart investors will also be able to generate outperformance.

## RELATED PRACTICE AREAS

- Corporate Real Estate and Funds
- Real Estate

## MEET THE TEAM



### **John Bennett**

Co-Author, London

[john.bennett@bclplaw.com](mailto:john.bennett@bclplaw.com)

[+44 \(0\) 20 3400 4363](tel:+442034004363)



### **Luke Mines**

Co-Author, London

[luke.mines@bclplaw.com](mailto:luke.mines@bclplaw.com)

[+44 \(0\) 20 3400 3175](tel:+442034003175)

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