

# Transforming REAL ESTATE *fund operations*

**Managers considering outsourcing to achieve operational efficiencies should assess their needs based on four criteria.**

**R**eal estate investment managers have experienced explosive growth over the past several years. However, the headwinds of extensive regulatory and market change, increased investor demands and fee compression could dampen future prospects.

According to State Street's 2019 Growth Readiness Study, the growth outlook is weakening across all types of asset managers, who are less optimistic about hitting their growth targets than they were just 12 months ago. Of the alternative asset managers surveyed, the biggest threats to growth over the next five years are: the equity outlook, political outlook and economic growth in key markets, as well as regulatory attention to investment fees. To be able to compete effectively, managers recognize the need to focus on their core business of sourcing, managing and transforming assets, while fulfilling

stakeholder requirements of greater transparency, better reporting and tighter accounting controls.

One solution to optimizing the operating model is to offload non-core tasks to a trusted partner. As with any journey, taking the first step can be the hardest. Managers should approach enhancing their operations more holistically in a process we call an "operational transformation." Operational transformation involves changing the operating model, adopting a risk-based approach to managing operations and deploying third-party solutions for non-core tasks.

To help managers frame an execution plan for transforming their real estate operations, below are insights and State Street's best practices gained from our experience supporting multiple clients, as well as the author's own experiences overseeing the real estate fund operations for a large asset manager.

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## Where to begin

In thinking about undertaking an operational transformation, managers should first assess their existing capabilities, as well as identify gaps and opportunities in getting them to their goal. This starts with defining the components of the organization's fund administration. Fund administration typically encompasses the back office and some middle-office functions necessary to successfully support the operations of a fund. This includes accounting, recordkeeping, financial reporting, audit and tax return support, capital call and distribution processing, investor anti-money laundering/know your customer reviews, and execution of all investor deliverables.

The next step is to decide which transformation structure is right for the business. There are three common models:

### 1. Outsourcing of new fund launches

When launching a new fund, the manager would maintain its current operational infrastructure, technology and staffing, while outsourcing additional headcount. By doing so, the manager will not add headcount as the fund scales. Single-strategy managers that want to enter a new strategy but lack operational expertise often opt for this model.

### 2. A full or partial conversion of existing funds

In a full conversion, the manager converts all of its historical data to the fund administration firm. The manager of an older vintage fund, perhaps in the fifth year of its 10-year fund term, that may not want to convert all of the historical data may choose a partial conversion. In this case, the manager may opt to have the administrator start with opening balances at the fund's new

fiscal year. This approach works well for managers that have a separate mechanism for tracking returns and investor historical data.

Under a full or partial conversion, the fund manager would continue to manage its operations and IT infrastructure until the conversion is complete; there will be a transitional period of overlap between the existing and outsourced operations. As part of the outsourcing process, managers will need to review the quality of their data and the age of funds. Managers should keep in mind the need for targeted hiring or transfer of employees to the third-party fund administrator.

Once the conversion is complete, the fund manager's in-house employees focus on fund oversight and front- and middle-office engagement. The third-party partner will manage the fund's administration and other back-office requirements.

Exhibit 1: Examples of operational transformation

Client	Initial drivers for change					Outsourced income
	Scale and growth	Self-administration	Technology	LPs	People	
Large, complex asset manager with \$80bn+ in private equity commitments and large private equity fund of fund business	x		x	x	x	<ul style="list-style-type: none"> <li>Expanded outsourcing and vendor consolidation solution allowed firm to focus more on growth (40,000+ investors).</li> <li>More efficient model is introducing opportunities to decommission systems (shadow book).</li> <li>Streamlined operating model allowed firm to focus on core business and investors and scale their fund of funds business to \$80bn with numerous product launches annually.</li> </ul>
Asset manager with \$21bn+ in private equity commitments and large private debt book. Complex closed-ended and evergreen structures	x		x	x		<ul style="list-style-type: none"> <li>Focus on technology and integration with administrator allowed the manager to efficiently scale and grow, while streamlining the review process and timeline.</li> <li>LP reporting enhancements driven by market forces (ILPA) and facilitated by operating model and scalability.</li> </ul>
A large, global alternative investment manager with a diverse and complex product offering	x	x	x	x	x	<ul style="list-style-type: none"> <li>A cohesive, bundled back-office outsourcing solution enabled client to reduce headcount and IT expenses, saving over \$4m annually.</li> <li>Automated client's reporting, reducing risk of error by 90% and enabled them to focus on enhancing investor returns, along with strategic product and asset growth and scale.</li> </ul>
Top 10 real estate manager looking to avoid major technology investment, reduce costs and simplify their business model	x	x	x	x	x	<ul style="list-style-type: none"> <li>Lift-out of personnel and proprietary technology to State Street, establishing a real estate Center of Excellence in Atlanta.</li> <li>Improved service delivery through a 25% reduction in reporting times.</li> <li>Transition of personnel from "back office" to "client service" created greater career development opportunities.</li> </ul>

Source: State Street.

### 3. A full lift-out of fund operations

A full lift-out includes technology and people. It involves the transfer of ownership of databases and systems, as well as fund administration. The fund administrator would retain the manager's staff and over time integrate the team into the fund administrator's infrastructure. The administrative work is immediately transferred to the fund administrator so that the team that remains with the manager — the "oversight team" — can quickly focus on fund oversight and asset and portfolio management. We typically see this with firms that are growing at a faster pace than their fund operational infrastructure can support.

Managers on this growth trajectory tend to require more dollars invested to upgrade their current accounting systems and technology; require more headcount, often as result of turnover combined with growth; and require a solution that can manage the increased volume of investors and their need for transparency.

There are several approaches as noted that may yield varying results depending on where the manager is in its lifecycle (see Exhibit 1).

### The execution plan

The execution process requires a tremendous amount of internal

reflection to understand the organization's key challenges and aspirations. It is critical to fully understand core strengths and which areas require a more focused effort. Once the type of transformation structure is decided upon, managers should conduct an in-depth evaluation in four areas: operations, technology, human capital and cost analysis.

#### 1. Operations

Operations covers processes, controls and risk environment. *Keep these best practices in mind before you transfer responsibilities:*

- Conduct a detailed review of the operational infrastructure to identify

gaps in your model, map the risks and create a governance framework. Identify areas typically outsourced, such as tax preparation and filing, property and fund accounting, and treasury and cash management to determine if these are strengths or weaknesses for the organization.

- Investor reporting and portals should be designed to track activity, provide insight and analytics, and deliver required documents. The ideal platform would have the ability to connect fund-level data with investor-level data.
- Create documentation that clearly delineates critical business processes, handoffs, dependencies and workarounds.
- Plan projects to clarify scope and establish a strong reporting structure to maintain control and establish strong KPIs.
- Move toward new technology, including analytical and investor tools.
- Assess the post-transition impact on other teams, such as asset management, investor relations and transactions teams that rely on data from specific technology systems.
- Data migration and whether to maintain historical data versus starting with opening balances.
- When evaluating the administrator's technology capabilities, pay attention to its investor portals, accounting platforms and analytical tools. Fund administration platforms typically

allow data to be tracked at each level of a fund structure, from the investor commitments and fund-level data through to the underlying real estate investment. These systems often involve a costly and time-consuming process of implementing and maintaining the technology in-house, which can be avoided almost entirely with a fund administrator.

### 3. Human capital

Assessing staffing needs may be the most challenging component of the outsourcing process. Ask a few

## 2. Technology

Conducting due diligence on your current technology stack, including applications, general ledger and cloud-based tools, will help you better understand process flows for critical operations, potential failure points and system dependencies. Investors require managers to have technology in place to provide detailed reporting on their investments and to provide a mechanism for transparency. Identifying and mastering the best technology applications that can support the reporting needs of investors is not necessarily a core competency of most managers, but is certainly expected of the fund administration industry.

*Best practices include:*

- Establish realistic targets for decommissioning or continuation of existing technology platforms.

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important questions: Can your existing team evolve to meet the needs of your future-state operating model? How do you transition the team from day-to-day fund accounting tasks to a risk-based approach using analytics? In the case of a lift-out, which individuals should move to the fund administrator and who should remain in an oversight capacity?

*Best practices include:*

- Conduct a thorough evaluation of intellectual capital ensuring appropriate resourcing of the oversight function and create a strong governance framework. While internal teams are often deliberately lean, a manager builds out staff with bench strength in areas like investor relations, compliance, valuations and security. For the administrator, hiring a large team of technical experts who support multiple funds makes financial sense. The cost of building a similar team in-house can be prohibitive.
- Oversight staff should be trained on the fund administrator's platform to develop future economies of scale and serve as a foundation to drive mutual organizational success.
- In a lift-out scenario, prepare the team for new roles and responsibilities under the future-state model. The team will no longer be responsible for detailed preparation of workpapers, but will now focus their attention on KPIs, risk metrics and strengthening internal operational controls.

Proper evaluation can help your workforce grow and enhance their roles, while the organization benefits from a stronger operating model that allows it to achieve its strategic goals. The decision to move specific staff to an administrator can be challenging. However, there are clear benefits for

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all parties involved. The team being lifted to the fund administrator may have opportunities to work with new clients, to move from a cost center at the fund manager to a revenue center with the new fund administrator, and career progression that is not contingent on the fund manager's growth. The team that is retained — the “oversight team” — expands their analytical capability, moves to provide enhanced support to the asset and portfolio managers, and maintains a higher focus on critical risk areas of the business.

#### 4. Cost

With the operational house in order, it's time to think about finances. Fixed overhead costs like back-office salaries and benefits in a growth scenario can be turned into a variable expense when outsourced. For example, most limited partner agreements (LPAs) allow for fund administration costs to be paid by the fund; many LPAs specifically allow for the cost of a fund administrator like audit, tax and legal professional fees.

*Best practices include:*

- When a fund is being wound down, the manager is saddled with fixed costs while not earning management fees to support the overhead and

infrastructure. An outsourced back office reduces costs.

- Consider the true cost of full-time hires, which not only includes salary and benefits, but also recruiting, training, developing and housing a team which equate to fixed costs. When using a third-party administrator, these fixed costs convert to variable costs that increase as new funds are launched and decrease as funds wind down upon reaching the end of their term.
- Consider the current projection of financial costs by category (personnel cost, occupancy, IT, outsourcing costs, others) for the next three to five years. This allows you to compare the costs of using a third-party fund administrator against your projected operating model cost as you make the cost-benefit analysis on your operational transformation decision.

## Conclusion

To keep the focus on managing and buying real estate assets, a fund manager can outsource its fund administration to a competent and trusted partner. A manager considering outsourcing should take an in-depth assessment of its own strengths and weaknesses and how a transition would impact its investors, operational infrastructure and other teams within its organization. A deep and robust evaluation of operations, technology, human capital and cost will help put an organization in a strong position to transform its operations. ♦

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