ALLVUE

BACK OFFICE CHALLENGES FOR

REAL ESTATE FUND CFOs

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A number of our current trends in private equity real estate are creating both opportunities and challenges for real estate fund managers.

Powerful shifts in regulation, investor attitudes and deal opportunities are bifurcating the industry into those managers that will be able to capitalize on these dynamics and those that will fall behind. While most attention is usually given to the fundraising and investment landscape, it is the back office that could ultimately provide the path to growth. GPs still bogged down by manual, spreadsheet-driven accounting and reporting processes expose themselves to undue risk, poor scalability, lost opportunity and security threats. The best investment teams, back office, and IR personnel in the world can easily find themselves playing catch up without having the proper operational foundation from which to work.

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The world of fund accounting and reporting is getting exponentially more complicated.

Real estate funds today look very different from those of just a few years ago. Driven by an increased interest from international investors along with the demand by LPs for more co-investment opportunities, GPs are facing more complexity in their overall fund structures.

A more diverse client base, coupled with the investor community's desire for greater direct Investment opportunities, the need for more blockers, JVs and other entities has created significantly more layers to the fund model. In addition, as GPs survey investor attitudes about the real estate landscape, they naturally look to bring new funds and strategies on board to capture allocations, adding to the expanding operating complexity. It's probably no surprise, then, why, in a recent survey, over half of real estate managers expressed improvement to their systems as a top priority.[1] For fund managers facing growing complexity in their back office model, two themes have emerged: the need for more automation, and better tools for information extraction.

Many GPs still find themselves in a spreadsheet-driven world. The advantages for using Excel are rooted in its low learning curve, affordability and widespread use. The most attractive feature, though, lies in its flexibility to model an infinite number of scenarios and relationships. This, however, can also be its greatest detriment. As a GP brings in more entities and relationships, the risks in maintaining control and consistency in governing the information grows exponentially. Links break, calculations are hard to keep track of, duplicative data entry occurs, and errors inevitably multiply. Maintaining allocations across investing entities, particularly around underlying transactions, can be a vexing problem. Codifying these types of calculations, at various detail and summary levels, can pose significant challenges when using spreadsheets as a fund accounting platform.

Another challenge being faced across many real estate fund managers is the attempt to convert the plethora of data that resides across various applications into high-value information, not only for investor reporting, but internally across the firm. There are numerous cross-department benefits in having immediate and flexible access to such information. Investment teams, compliance, investor relations, finance — all can gain advantages in the decision making process in terms of portfolio analysis, risk management, client reporting and controls. However, it is notoriously difficult to extract meaningful insight from data that lives in variety of spreadsheets and applications. While a GP can turn to the myriad data warehousing and business intelligence (BI) services available, these applications are built for general corporate activity, not for the industry-specific needs of private equity and real estate managers, limiting their usefulness. A more optimal solution often involves incorporating an underlying technology than can provide the intelligence functionality of a BI service that "sits" on top of a single data source. In this scenario, various teams all work with the same information, minimizing redundancy and errors, while streamlining information sharing and decision making.

The new age of transparency for LPs means more detail and quicker turnaround times.

It's been well documented that institutional investors are looking for more transparency from their private equity and real estate managers. In fact, when private equity managers were recently surveyed as to the biggest operational trends they are seeing, the highest response, at 76%, was the request from their investors for more transparency.[2] It's easy to assume this trend extends to private equity real estate as well.

As private capital becomes a larger part of investors' portfolios, the information expectations from the asset class are being evaluated much in the same way as their public securities counterparts. Investors are increasingly looking at their portfolios in totality across allocations, exposure and attribution. Risk management is now being extended into the private markets, so that investors can have a holistic view across the entire portfolio of where their exposures lie in terms of geography and sectors. For example, in the summer of 2016 when the UK voted to leave the EU, many publicly traded REIT's with UK holdings traded down significantly. Given this new-found attention of understanding portfolio-wide risks, no asset class was spared in having to answer investors on their exposure to the UK market. Direct real estate investments, being a non-liquid asset, limits managers' ability to adjust their portfolios in the same manner as a public REIT, but, nonetheless, investment committees are looking across their entire underlying holdings to better manage risk.

Maintaining "application silos", where fund accounting, CRM and reporting processes are not integrated across the firm, inevitably hampers the process to transform raw data to the useful intelligence that investors are now requiring.

When a GP struggles to turn around investor information requests in a timely manner, it creates fractures in the GP-LP relationship. Perhaps this is why operational due diligence by investors is taking a greater role in the manager evaluation process. Institutions are looking for more insight into a potential manager's valuation, risk, operations and reporting processes. Due diligence questionnaires are incorporating more back office-related topics than ever before. More granular information on underlying companies and properties - tenant data, debt levels, operating metrics - are no longer "nice to have," but are requirements. The problem becomes compounded when investors also ask for specific, one-off information requests above and beyond standard reporting schemas. LPs will now look closely at a potential manager's ability to provide this information in a timely manner and will benchmark their abilities in this area vs. other managers as part of the evaluation process.

For managers that still rely on spreadsheets or disparate applications to house their data and processes, this represents not only goodwill risk but also opportunity costs, as investors expect "institutional-quality" back offices to meet their reporting and information needs.

The importance of security and information control cannot be overstated.

Across corporate America, business leaders are facing a growing and increasingly sophisticated series of threats from hackers and bad actors. Network penetration, unsecured mobile devices, email phishing, malware, ransomware - all pose a significant risk to a firm's privacy, security and, most notably, reputation. With recent headlines in mind, one could think that it's only the largest of businesses that come under threat. But, in a recent survey posed to the private fund manager community, over half responded that they have experienced some form of cyber-attack.[3] One of the biggest exposures a GP faces in addressing their various security threats is In using email as a Communications platform, as It Is easily compromised by phishing and ransomware programs. Email is inherently an unsecure communications channel for GPs to use when information needs to be disseminated outside the organization, whether it be to Investors, prospects, administrators, or other related parties. It is because of this weak link in the security ecosystem that many GPs turn to an investor portal to report to outside entities. Implementing a portal solution greatly reduces the reliance on email and can therefore help minimize two of the most prominent types of security threats - phishing emails and ransomware, where malevolent attachments are disguised to the recipient as being trust-worthy.

INTEGRATED BACK OFFICE PLATFORM

BUSINESS INTELLIGENCE

COMPLEX FUND STRUCTURES

- Provide scalable infrastructure to support firm growth - new funds JVs, co-investments
- Increase efficiency among teams with shared data
- Support better decisions with accurate and timely data

WEB PORTALS

TRANSPARENCY FOR LPs

- Facilitate operational due diligence
- Reduce reporting errors
- Respond more quickly to LPs questions

FUND ACCOUNTING

REGULATORY REPORTING

- Facilitate reporting across complex fund structures
- Implement controls and processes to address regulators' requirements
- Create audit trails to facilitate SEC exams

CRM

SECURITY THREATS

- Control the flow of data outside the organization
- Address investor concerns around cyber-preparedness
- Reduce reliance on unsecure email

Changes to U.S. regulations and tax laws can be a moving target but need to be operationally addressed.

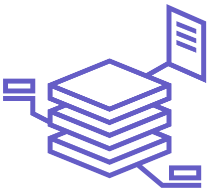
There have been significant changes to the regulatory environment in the investment management industry in the past few years. The private capital markets are no exception. AIFMD, FATCA/OECD, and Form PF are just a few examples of how regulatory bodies have been imposing new reporting and disclosure requirements on GPs. The SEC has also been stepping up their examinations of private equity and real estate managers. Notable areas of examination have included disaster recovery, cyber security, anti-money laundering, compliance procedures, custody arrangements, valuation practices, internal controls and marketing practices - to name a few. Potential changes in the tax laws, particularly around carried interest, is also another point that bears watching.

An important factor GPs need to consider when addressing these challenges is the state of their data management and ability to extract information at various levels in the fund operating layer. The most robust data repository Is of little use unless key information can be pulled from it - quickly and easily and without error. The SEC and FCA are rarely keen about delays.

Spreadsheet-based back offices run significant risks in maintaining the data, control and processes looked for by auditors. When information sits in various applications, without the ability for straight-through processing, it becomes notoriously difficult to build the controls and reporting procedures to meet compliance standards. Moving to an integrated technology platform should provide the following attributes to address regulatory requirements.

- Flexible reporting capabilities to provide any information necessary as per the request, in a timely manner
- The ability to extract and subsequently download the underlying data should it be necessary
- An audit trail for both client and prospect communication
- An adaptable system to address changing rules and regulatory requirements
- The ability to implement necessary checks and balances while adhering to the internal workflow

SUMMARY



It’s become Increasingly clear that maintaining the “operational status quo” for real estate managers is going to cause challenges for firms looking to grow their businesses. As GPs look to expand their investor base through new types of investors and co-investment opportunities, fund structures will only grow in complexity. Transparency and reporting demands will certainly add to the effort.

Regulations, compliance and cybersecurity risks will continue to pose challenges, particularly for those firms without a cohesive and scalable underlying technology solution. Many GPs will need to re-think how their information architecture can provide support across the firm - from the investment team to the back office to investor relations. Leveraging a proper technology solution can go a long way in managing these operational risks.

[1] PERE CFO and COO 2016 Forum
[2] 2016 SEI Private Equity Survey
[3] “Cybersecurity in Private Equity” Private Funds Management, January, 2016

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