

Outsourcing Gains Traction with Real Estate Investment Managers

Can fund administrators meet rising expectations?



Real estate investment administration – commonly known as fund administration – is expected to proliferate in the coming years, after a long history as a cottage industry. As more real estate investment managers turn to outsourcing their back-office operations, many lessons can be learned from those who have already made the journey.

Real estate investment managers that outsource business functions have a very different perspective than those that do not. This divergence creates an interesting juxtaposition for learning about what makes an outsourcing relationship successful and what drives real estate investment managers to outsource in the first place.

More managers plan to outsource at least some of their functions, primarily due to increased pressure from their limited partners (LPs) and rising technology-related expenses, according to a recent survey conducted by Wealth Management Real Estate and Informa Engage. These managers can look to those that have already outsourced to learn what works well and where they have encountered challenges.

“Perhaps the lack of outsourcing in the industry up until this point speaks to a lack of appealing options instead of an inherent desire not to outsource,” notes Josh Herrenkohl, Senior Managing Director of FTI Consulting. “But the tides are turning, and options today are more plentiful than they were just a few years ago.” The independent survey, conducted on behalf of FTI Consulting’s Real Estate Solutions practice, polled a wide range of real estate investors, including institutions, pension funds, public and private REITs, sovereign wealth funds, investment managers, and private equity firms.

Most reported total AUM of at least \$1B (60%) including 22% with AUM of at least \$20B. Respondents were active in a variety of property type segments, most commonly office (50%), multifamily (47%) and retail (43%).

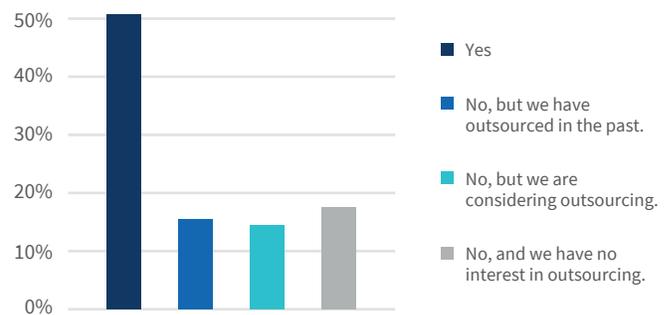
Half of all respondents (51%) outsource at least some business functions/activities (Functions are listed in table to the right). An additional 15% are considering outsourcing and 16% have outsourced in the past; 22% of those

currently outsourcing have considered moving certain outsourced functions back in-house.

Just under half of those currently outsourcing are considering outsourcing additional functions.

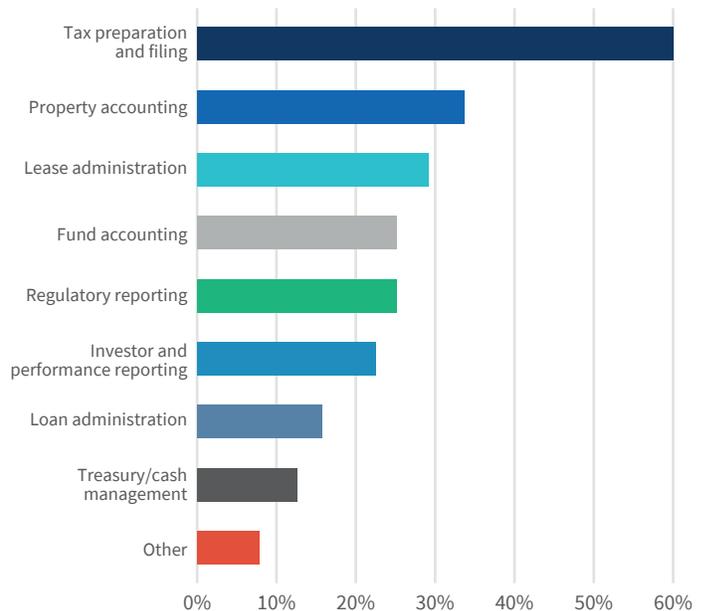
Currently Outsourcing?

Half of all respondents (51%) report outsourcing at least some business functions/activities. An additional 15% are considering outsourcing.



Outsourced functions include tax preparation and filing, property accounting, lease administration, fund accounting, regulatory reporting, and investor and performance accounting.

Functions Currently Outsourced



LPs push for outsourcing

The outsourcing wave in commercial real estate began roughly 10 years ago, driven by managers’ desire to get rid of the painful headaches related to non-strategic functions. The challenges that drove them down this path ranged from HR issues to financial control issues, and though there was emerging interest in outsourcing generally, the decision was based solely on the manager’s interest in being laser focused on their core, strategic functions rather than any pressure to do so from outside investors and stakeholders.

“In those early days of outsourcing fund management functions, real estate investment managers hoped to improve the effectiveness of their operations but had no real expectation of driving significant cost reduction or achieving materially increased efficiencies,” Herrenkohl notes. “Unfortunately, their expectations were met by a reality that wasn’t far removed. By and large, they received service from non-real estate industry professionals, leveraging antiquated or not-fit-for purpose technology.”

Over the past decade, the real estate investment community’s overall attitude regarding outsourcing has slowly shifted. Investment managers initially thought of it as a commodity and then began to think of it as a value-add.

“Today, however, beyond cost savings, managers wanted to realize true value from outsourcing,” according to Josh Wilcox, managing director of FTI Consulting. “They want access to organizations that understand real estate as well as they do, and access to real estate-specific technologies rather than more generic options. The emergence of the property technology (PropTech) industry has only accelerated that desire.”

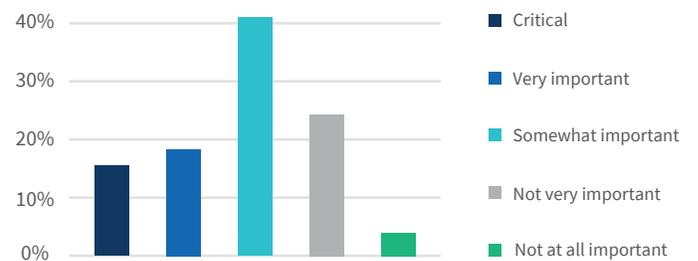
As a result, companies are now thinking about outsourcing far more strategically and asking themselves questions like: “Will I attract more LPs if I outsource?” and “Will I be able to manage my investments better because outsourcing provides a clearer picture of asset-level performance?”

The real estate industry lags other industries in many other aspects with respect to operational maturity, so it’s no surprise that its move toward outsourcing has been slower than other sectors. Hedge funds, for example, embraced outsourcing many years ago, primarily because their LPs demanded more transparency and more customized, frequent reporting. For example, hedge funds outsource nearly all relevant functions considered by this survey. The challenges and questions that a hedge fund would face from prospective LPs during fundraising by not outsourcing are reason enough to outsource. In contrast, only roughly 40% of real estate investors outsource functions (broadly defined), with the majority of real estate owners currently performing most business functions in-house. “So far, real estate LPs haven’t generally demanded that owners/GPs outsource any particular business functions, but that day is coming soon,” Herrenkohl notes. “We expect real estate will follow the same path as hedge funds.”

Approximately one in four LP respondents who participated in the survey believe it is “very important” or “critical” for a fund manager/GP to use a third-party administrator (23%). An additional 57% believe it is “somewhat important”.

Importance of Fund Admin Having an SOC-1 in Place

A third of LP respondents (33%) believe it is “very important” or “critical” that a third-party administrator have an SOC report. An additional 41% believe it is “somewhat important.”



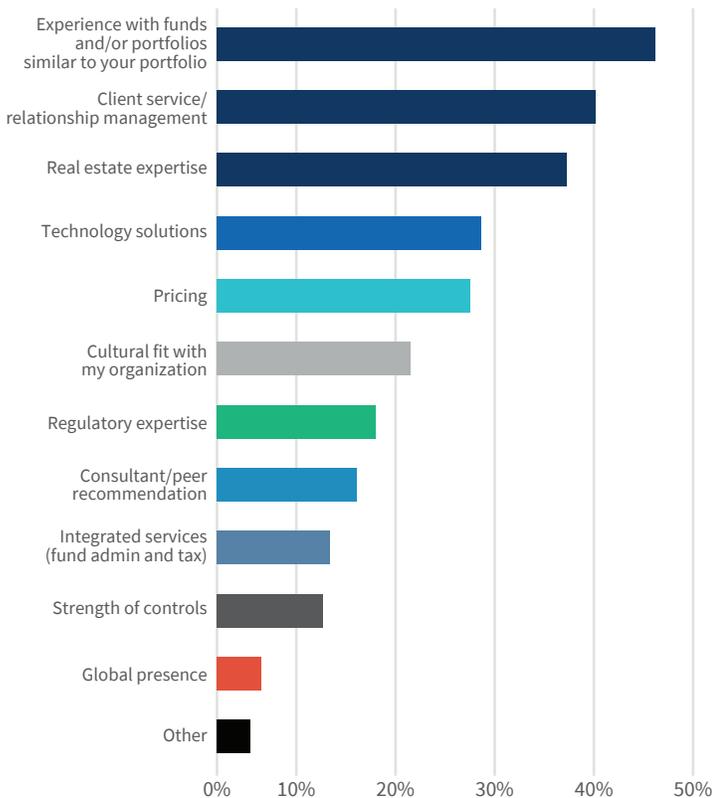
Similarly, most LP respondents (63%) believe it is “very important” or “critical” for third-party administrators to have independence from asset level providers. An additional 23% believe it is “somewhat important.”

Understanding the value proposition

Real estate firms that currently outsource tend to prioritize different attributes of outsourcing providers than those that do not outsource. They value knowledge, service, and experience over price.

Among those real estate investors that already outsource, the three most influential factors in the selection of a fund administrator are experience with funds and/or portfolios similar to theirs (47%), client service/relationship management (40%), and real estate experience (37%).

Priorities for those that have already outsourced



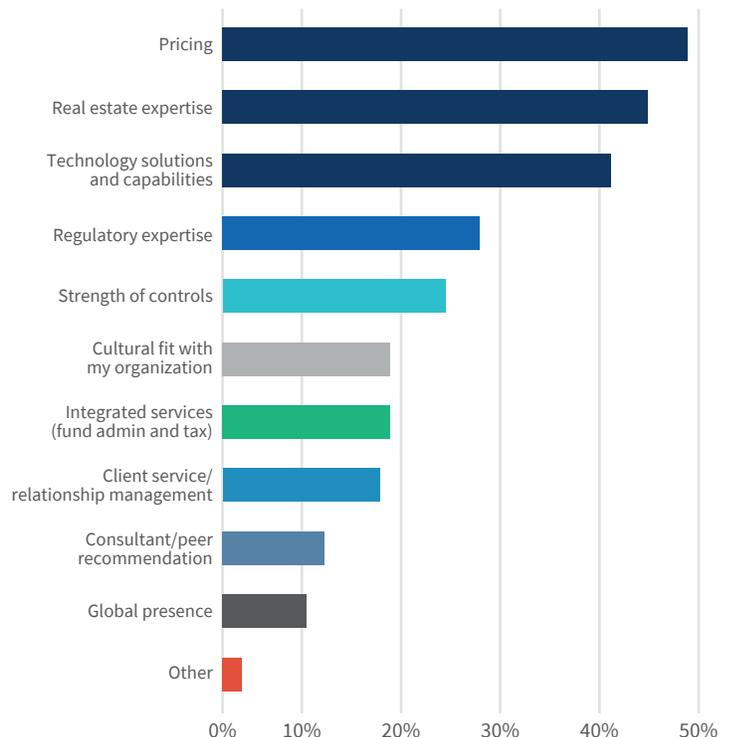
In contrast, firms that don't outsource think of it in terms of price rather than value. Nearly half of survey respondents that have not yet outsourced identified pricing as the top priority, while just 27% of respondents that already outsource listed pricing as most important.

The survey proves that owners that have never outsourced consider it to be a commodity, which leads them to focus on price rather than client service,

relationship management, added value via integrated services, or cultural fit.

For real estate investors that have not yet outsourced, respondents report the most influential criteria in selection of a fund admin would be pricing (49%), real estate experience (45%) and technology solutions and capabilities (41%).

Priorities for those that have NOT yet outsourced



In fact, 38% of respondents said they have not outsourced due to insufficient cost savings, while 27% said they have not found the right partner.

“Owners that have experience with outsourcing have realized that you get what you pay for when it comes to providers,” Wilcox says. “While savings are possible, focusing only on price when evaluating outsourcing providers can end up costing companies more in the long run.”

The pricing models most commonly contracted for are per fund based on services (45%) and per property based on property type (40%). Respondents were split regarding geographic preferences for their fund administrators, with 60% preferring administrators in the same country or even the same space, and 40% being fine with offshoring.

Elevating vendors to partners

Historically, outsourcing providers struggled to provide a high level of client service, which soured many real estate owners on outsourcing. Their less-than-ideal experiences are still discouraging many firms from outsourcing today.

When investment managers outsource, they largely relinquish control over the performance of those functions, and that lack of control can be terrifying for many executives. The conundrum that many owners face is whether they should try to manage everything in-house or trust an outsourcing partner.

“The control aspect of outsourcing makes it even more important for owners to find partners they can really trust,” Herrenkohl points out.

Owners that consider outsourcing companies as true partners have a completely different relationship than those that see them simply as vendors. In short, thinking of an outsourcing partner as an extension of the internal team leads to more successful outcomes.

“Instead of reducing outsourcing companies to vendors, why not elevate them to partners?” Herrenkohl suggests, adding that a successful outsourcing relationship is like a marriage in many ways. “Similar to a supportive, loyal spouse, a strong outsourcing partner will be there in good times and bad, celebrating with clients when they win and being supportive when times are tough. And most importantly, an outsourcing partner will watch out for its clients and want what’s in their best interest.”

Real estate expertise matters

True outsourcing partners strive to understand their clients, from culture to communication preferences and everything in between. Ideally, they design customized solutions to fit their clients’ needs so they match the way those clients want to run their business rather than forcing them to accept solutions that don’t fit.

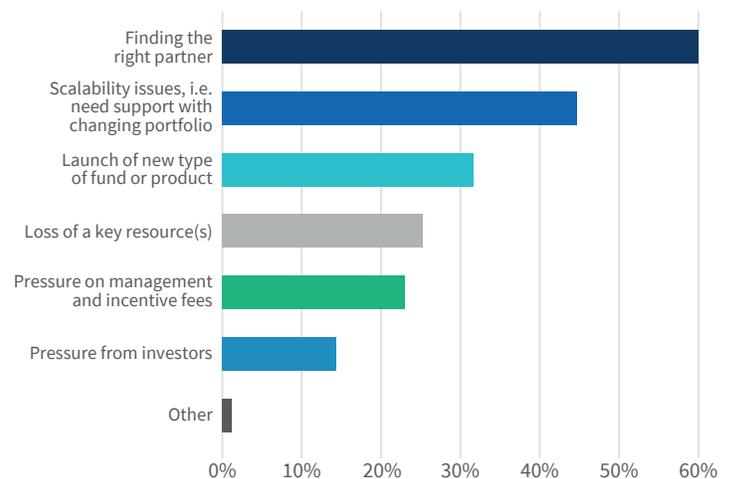
Forty-seven percent of companies already outsourcing ranked experience with similar portfolios as a top priority, while 37% indicated that real estate expertise was important. Likewise, 45% of respondents not yet outsourcing said real estate expertise is important when selecting a fund administrator.

Of equal importance, outsourcing partners proactively provide advisory support to help their clients meet both short and long-term objectives, whether it’s setting up a new fund structure or attracting more LPs.

“When outsourcing partners have real estate expertise and experience with various real estate fund structures and property types, it’s easier for companies to trust the work that their partners complete,” Wilcox contends.

Those not considering outsourcing indicate that finding the right partner (60%) and scalability issues (45%) might positively influence their decision to outsource. Another 32% say they’d consider outsourcing when launching a new fund or offering. “It’s quite possible that those less inclined to outsource today may, in fact, decide to pursue that path if the volume of transactions significantly increases, as we expect to be the case later in 2021 and into 2022.” says Herrenkohl.

Factors with Potential to Positively Influence Decision to Outsource



Accessing best-in-class technology by outsourcing

Today, most real estate firms either cannot afford to implement best-in-class technologies or do not have the interest or in-house expertise to do so. So, what is the solution? Outsourcing.

The big challenge for companies today is not gathering data, but managing it and making sense of it. Real estate data is still very siloed, disaggregated, and in different formats, which presents a challenge for the industry as a whole.

The advent of the PropTech movement has finally delivered solutions that can help real estate organizations solve complex challenges that have plagued the industry for years. But many organizations do not have the fortitude to undertake multi-year programs that cost millions of dollars.

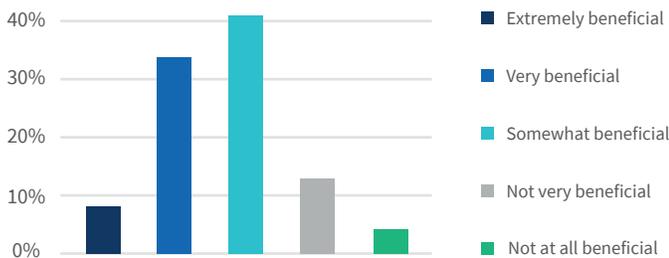
A solution, particularly for organizations that are smaller than the very largest in the real estate industry, may be to buy technology “by the drink,” effectively allowing many real estate companies to spread the cost of innovation and technology across them and their peers. The application of this approach can be extremely broad, applying not only to data technologies, but also to workflow, automation and artificial intelligence, among many others.

“While this new approach to leveraging the benefits of technology will allow smaller and mid-sized managers to participate in the innovations of technology, they would be wise to seek a partner who can combine the capabilities of technology with the expertise of their people,” Wilcox advises.

Integrated Tax and Fund Admin

Most companies that are satisfied with their outsourcing partners have integrated tax and accounting functions into their outsourcing model. The survey found that 83% of respondents believe it is at least "somewhat beneficial" for outsourcing partners to deliver integrated tax services.

Beneficial for Fund Admin to Also Deliver Integrated Tax Services?



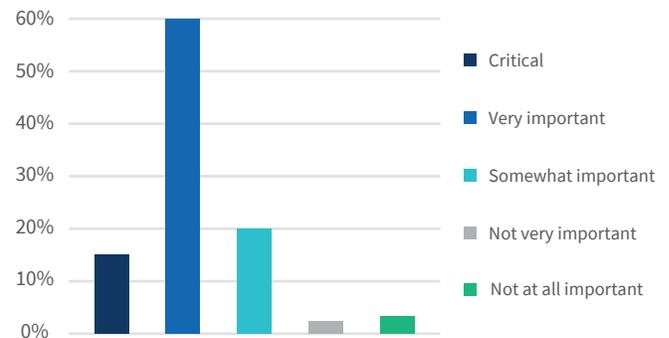
Choosing an outsourcing partner that offers integrated tax and accounting services improves efficiency and reduces

the possibility of errors related to knowledge transfer between different accounting and tax firms. Plus, it’s easier for owners to manage one relationship instead of two. Additionally, owners can receive proactive advice regarding the best ways to structure investment vehicles and funds for tax purposes.

Oversight of Third-Party Asset Level Providers

Independent oversight of third-party providers is another outsourcing service that real estate owners appreciate. Three in four respondents currently outsourcing believe independent oversight of other third-party providers, particularly at the asset level, is “very important” or “critical” (75%).

Importance of Independent Oversight of Third Party Providers



Likewise, 66% of respondents not yet outsourcing said independent oversight of third-party providers is “very important” or “critical.” And 63% of LPs said it was “very important” or “critical.”

Outsourced reporting ensures that all data and reports from various sources and providers is correct. Because an independent company is reviewing and attesting to the accounting information, there’s a greater level of transparency, which creates more trust from investors and LPs.

Real estate managers are willing to take the necessary steps to ensure that their investors and LPs continue to invest capital with them. Increasingly, those that are committed to fulfilling their fiduciary responsibilities are

heeding the wishes of their investors and LPs by outsourcing business functions. Yet, it appears that this trend has only just begun.

“We expect that institutional real estate investors, perhaps at the encouragement of their investors, will increasingly choose to focus on their strategic imperative, investment and asset management, and leave other functions to third-parties who, in turn, consider it to be their strategic imperative,” Herrenkohl said.

About the *Outsourcing and Commercial Real Estate Investment Survey*

A wide range of commercial real estate investors, including institutions, pension funds, public and private REITs, sovereign wealth funds, investment managers, and private equity firms participated in the *Outsourcing and Commercial Real Estate Investment* survey from February 5 – March 4, 2021. Sixty-six percent of the 215 respondents reported total assets under management (AUM) of at least \$1B, including 22% with AUM of at least \$20B. Respondents were active in a variety of property type segments, most commonly office (50%), multifamily (47%), and retail (43%).



JOSH HERRENKOHL
Senior Managing Director
josh.herrenkohl@fticonsulting.com



JOSH WILCOX
Managing Director
josh.wilcox@fticonsulting.com



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