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## THE 2010 GUIDE TO PRIVATE EQUITY REAL ESTATE FUND ADMINISTRATION AND TECHNOLOGY

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# The real cost of managing your real estate fund

Launching a private equity real estate fund is not just about raising capital and buying properties. The transparent – and hidden – costs of maintaining a platform can also be large and complex. **By Michael Sala**

Let's face it. Starting up and operating a real estate investment fund is a complex undertaking that requires significant real estate finance domain expertise.

From the first capital commitments to initial property acquisitions, from cash flow tracking to capital calls – day in and day out, chief financial officers have their work cut out for them.

In the early days of the life of a fund, managers are raising capital and getting commitments; only when these are in place are infrastructure-related questions raised. Soon thereafter, when investor commitments are made and acquisitions close, the CFO must provide administration support.

Over time, it becomes clear that managing the requisite monthly and quarterly reporting is an intense, manual undertaking.

To support this, CFOs have a choice. They can build the administrative function themselves – including a myriad of choices about people, processes and technology – or outsource their fund administration to a provider.

A good decision at this point requires some hard thinking.

How much senior management time is actually devoted to administrative tasks and diverted from value-added work? What are the hidden costs? Can this be quantified?

## Outsourcing today

Outsourcing has become common practice for CFOs across industries worldwide, in part due to the influence of Six Sigma<sup>1</sup> and other process re-engineering approaches.

Outsourcing offers two major advantages for most CFOs. The first is the attractive option to move from a variable to a fixed cost structure. The second is the freedom for managers to focus on their core capabilities; in this case, the value-added fund and investor services that make all the difference in today's competitive market.

As might be expected, hedge funds have been by far the largest adopters of outsourced fund administration to date, followed by private equity firms. While private equity real estate funds manage more than an estimated \$414 billion in commitments<sup>2</sup>, they have lagged behind other types of funds in terms of outsourcing.



Sala: assessing costs

## Key CFO questions:

- What tasks or burdens are preventing you from focusing on value-added functions?
- How agile is your firm in terms of forming new funds, buying new properties and accessing market opportunities?
- How confident are you that your real estate assets are performing well against industry benchmarks?
- What challenges has your firm faced regarding staffing, hiring or replacing key fund administration employees?

<sup>1</sup> Six Sigma is a highly disciplined process focused on developing and delivering near-perfect products and services. To achieve Six Sigma Quality, a process must produce no more than 3.4 defects per million opportunities. An "opportunity" is defined as a chance for nonconformance, or not meeting the required specifications. <http://www.ge.com/en/company/companyinfo/quality/whatis.htm>

<sup>2</sup> According to Andrew Moylan of Preqin, interview 5 August, 2010

There are several reasons for this. First, real estate fund structures are highly individualistic, with no two transactions the same. As such, processing requires a keen, educated eye to capture the correct accounting transactions and compliance documentation. Second, start-up CFOs are typically unaware that an option to outsource exists before they commit resources to building their in-house infrastructure.

Finally, there is the question of availability. Up until recently, fund administration has not been a well-defined market offering tailored to real estate fund managers. For years, CFOs simply had no option but to hire and process internally, because of a lack of viable market offerings to choose from.

As the market has matured, CFOs have found themselves wondering: just when does it make sense to outsource?

A cost/benefit analysis may help quantify the cost of fund administration, a vital first step in understanding the fund's true costs. In this article, we explore some of the key questions and criteria you should be asking about the real costs of managing your real estate fund.

## The cost of people

When a new fund is raised or a key employee departs, fund managers can find themselves scrambling to recruit, train and retain skilled fund finance professionals.

Some managers only feel the pain of these people-related costs when they're hiring – and then only consider pay and benefits.

However, both cost accountants and human resources professionals point out that managers with this mindset are ignoring significant hidden costs. Some people-related tasks and costs are straightforward and transparent, such as hiring a recruiter or providing the necessary technology and connectivity and/or physical workspace.

Others, by their very nature, are voracious consumers of managerial time, and difficult to extract from a cost/benefit analysis. To help uncover these hidden expenses, an experienced human resources professional recently shared some insights into the key people metrics of this business.

### Hidden costs of internal staff

When hiring new employees, general partners need to consider more than just pay and benefits – not just the time spent in sourcing and hiring talent, but also training and managing staff

TASK	HIDDEN COSTS	IMPORTANT CONSIDERATIONS
<b>Sourcing/hiring</b>	Interviewing time: four to eight hours for each candidate means between 32 hours to 64 hours per hire  Administrative time: debrief, reference and background checks, drafting the offer letter	Rule of thumb: on average, managers interview eight candidates in order to hire one
<b>Training</b>	Managerial time: five hours a week per employee for coaching	Training time: employees need to get up to speed and be independent, taking six to nine months, perhaps even longer with a larger organisation.  Evaluation time: two years before determining if hiring cycle must begin again
<b>Pay</b>	Time spent evaluating competitive pay	Existing employee pay in a normal market with two percent cost of living adjustment annually – employers can expect a five to 10 percent annual increase in total compensation for performing employees
<b>Benefits</b>	Managerial time spent negotiating benefits with provider and enrolling new employees	Cost of benefits in the future
<b>Managing</b>	Managerial time: average 15 percent of total working hours per week	Personal coaching: directing and maintaining priorities

Notes: Hidden costs of internal staff refers to a generally accepted metric for a normal employment market.

Source: Dan Conroy, of Henderson Harbor Search, interview, July 2010

### The costs of internal processing and reporting

Real estate funds' monthly and quarterly processes are designed to ensure efficient operations. For the CFO, this involves a whole host of protracted, cyclical administrative tasks, including:

- Property operators must provide financial and operational data for each property in the fund. With the demand for more transparency created by recent investment scandals, managers must provide detail down to the owned asset level.
- Capital call and distribution processing require massive Excel workbooks with no defined workflow or controls, linked together by custom formulas engineered on a one-off basis.
- Managing cash receipt and distribution requires efficient cash management, and CFOs can effectively leverage bank services that support these processes.
- Valuation of properties requires maintaining a clean record of periodic valuation integrated with core accounting processes, and a detailed awareness of market lease assumptions (attributes) which vary between regions and asset types.
- Quarterly financial reporting involves accumulating all the data necessary to create financial statements, including asset books and records for fund consolidation and delivery to investors.
- Costly annual audits: Excel spreadsheets used as a main cal-

culcation engine and book of record can raise audit concerns.

- CFOs who are not supported by state-of-the-art automated processing and reporting can raise concerns during annual audits, prolonging the costly, time-consuming audit process.

Designing, managing and re-engineering these critical processes requires substantial commitments of management time and attention – thereby incurring real, if hidden, opportunity costs.

### The cost of technology

Technology heightens your efficiency, but comes with some significant costs of its own. Establishing repeated processes and acquiring, managing and upgrading the technology to support them may well be the biggest internal challenge that real estate funds face today.

The typical technology investment in the first year of a new fund is likely to be in the significant six-figure range. This includes a mandatory, all-encompassing fund administration platform, an integrated portfolio and asset management solution and an investor communication portal.

To properly assess the costs for each, you should identify the hidden expenses *in addition to the outright costs* of purchasing the hardware and software and maintaining the system. A similar approach should be used for those separate costs of maintaining adequate disaster recovery for all of your books and records.

### Hidden costs of fund administration technology

In identifying the costs of introducing an all-encompassing fund administration platform, GPs should also consider the hidden costs of buying technology, including time spent on evaluating systems, implementation and maintenance

TASK	HIDDEN COSTS	IMPORTANT CONSIDERATIONS
<b>Evaluation</b>	Time: requirements, RFP process, demonstrations, vendor visits, scorecards.	Do you know your requirements?
<b>Implementation</b>	Time: scoping, project management, parallel processing of old and new system/process, process re-engineering, un-met expectations  Economic: customisation, scope creep, sub-par implementation	What if the implementation is unsuccessful?  Can you assure continuity of resources, both internally and for your vendors?
<b>Software</b>	Time: negotiating contract  Economic: legal fees, unforeseen maintenance fees, further customisation	Do you have external counsel with technology background?
<b>Hardware*</b>	Economic: additional network/IT resource time, periodic server replacement and maintenance	Do you have in-depth knowledge of complex hardware requirements?
<b>Business continuity*</b>	Time: designing and testing plan, failure to execute	What if your plan doesn't work? What happens to your data?

\* Assumes hosting technology in-house



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**Real estate:** technology and fund admin as important as bricks and mortar

### The real cost decision

Once upon a time, real estate fund CFOs had no choice but to grow their own in-house administration. Today, the industry has matured, and CFOs have outsourcing options undreamt of even five years ago.

The decision to outsource poses a challenge to conventional cost accounting thinking for many funds. And the question now becomes – what is the real cost of dispersing the focus of a talented executive team? For fund managers, this introspective exercise can be the start of a tantalising line of questioning:

- “What would happen to my overall fund performance if I took steps to alleviate some operational burdens?”
- “What if I focused more time on developing an exceptional executive team, attracting investor capital or identifying assets that we can use to maximise return?”
- “What would my IRR look like in such a brave new world?”

Many funds have found that alleviating their administrative burden has many positive outcomes, among which are:

- Increased focus on core capabilities: In an increasingly competitive market, identify new opportunistic assets that meet the fund’s investment objectives.
- Flexibility and speed: The ability to quickly alter asset and portfolio strategy based on rapidly changing market conditions.
- Better information: Use your in-house market and asset expertise to create better, more accurate market lease assumptions, forecasts, models and strategies.

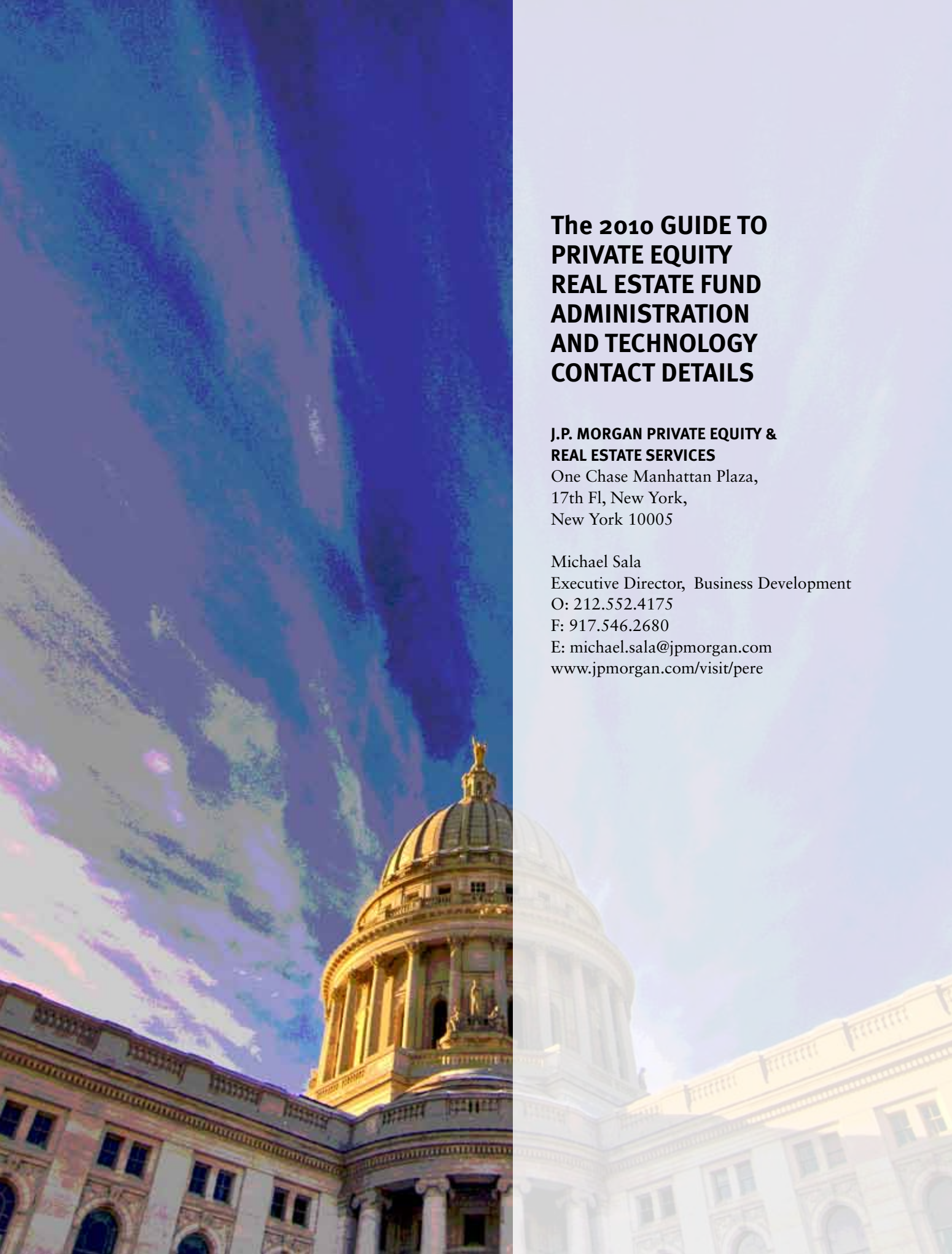
Could these be in your future, too? □

*Michael Sala is an Executive Director of business development for real estate fund managers for J.P. Morgan Worldwide Securities Services. J.P. Morgan provides middle and back office outsourcing of fund administration services such as fund and partnership accounting, tax support and comprehensive reporting services for real estate fund managers and limited partners. J.P. Morgan also provides a wide range of complimentary services to the real estate community including transaction advisory, cash management, credit products, escrow, foreign exchange and derivatives.*

### Can your fund administrator do this?

Not all providers are created equal. Be sure to ask any potential providers whether they offer these important capabilities:

- Leverage an integrated data warehouse encompassing portfolio, property, lease, occupancy, investor and fund accounting data
  - Integrate with an easily updatable contact management system
  - Offer a cutting-edge online portal where investors can see information at any time
  - Provide an online communication portal for fund-to-administrator instruction to facilitate fund operations
- Provide full disaster recovery for all books and records, supported in an offsite, secure environment, stored and backed up against any eventuality
- Constantly look to the future, evaluating the best options for sourcing and implementing the next new technology
- Offer related products to meet growing fund, portfolio and organisational needs



## **The 2010 GUIDE TO PRIVATE EQUITY REAL ESTATE FUND ADMINISTRATION AND TECHNOLOGY CONTACT DETAILS**

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