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real foundations
Twenty Years of Making Real Estate Run Better

Optimising performance by tapping the power of forward-looking information

Forward-looking information (FLI)

Most available real estate data — on which industry professionals base a wide range of important decisions — is historic or "backward-looking." However, when managing risks, particularly those related to real estate investment, analysts would be well served to also gaze into the future using forward-looking information or FLI.

Enterprise-level tools (often based around an enterprise resource planning, or ERP, system) are becoming increasingly sophisticated and capable of managing more aspects of real estate investment, including the associated risks.

Geoffrey Dohrmann's October 2019 *IRE Europe* editorial, "What *is* risk?", was an interesting discussion of risk in real estate investing. He examined what it is and how it can best be managed, while also recognising that even the performance metrics to do so remain difficult for the global industry to agree upon.

Meanwhile, there's an increasing appetite for risk among investors today. Many are seeking higher returns at the end of what they believe are the final stages of the current economic cycle. This trend was highlighted by the *Global Investment Intentions Survey 2020,* published jointly in January 2020 by three leading real estate investment associations: the Asian Association for Investors in Non-Listed Real Estate Vehicles (ANREV), the European Association for Investors in Non-Listed Real Estate Vehicles (INREV), and the Pension Real Estate Association (PREA).

The survey indicated that both North American and Asia Pacific investors plan to more than double their allocations (from 15 percent to 37 percent, and from 3.3 percent to 7.2 percent, respectively) to opportunistic investments between 2019 and 2020. Interestingly, European investors slightly reduced their own allocations to such higher-risk investments (from 5.6 percent to 5.4 percent), preferring to focus on core.

Is this rational behaviour for each group of investors? Do they understand and are they properly addressing the risks they are taking? And how can we even begin to formulate fact-based responses to these questions?

Fortunately, enterprise-level tools (often based around an enterprise resource planning, or ERP, system) are becoming increasingly sophisticated and capable of managing more aspects of real estate investment, including the associated risks. This includes the range of asset classes being managed, functional depth and breadth, speed and ease of operation, and region-specific requirements such as "local" business practices or legislative requirements. As these ERP systems extend "upwards" to asset and portfolio modelling, they can generate multi-point (often high, mid-point and low) forecasts.

However, a majority of organisations today are using models for underwriting individual investment tools built on spreadsheets. While this offers a high degree of flexibility to capture the specific nuances of each asset, it typically provides only single-point "best guess" forecasts.

Common shortcomings

The issues with most underwriting models are well known by investment management professionals, but often not addressed. These include:

Complexity

Commonly used models usually require significant effort to maintain, and fully understand, discouraging robust analysis.

Single-outcome scenarios

Most models portray only one outcome rather than a range of potential, real-world outcomes, offering little visibility into the volatility, the range of upside opportunity and downside risk, or the shape of that risk curve.

Reliance on spreadsheets

Spreadsheet tools are prone to error, manipulations and usage inconsistencies across the entire portfolio and between teams and individuals.

Suboptimal data flow

Typical models rarely enable the easy flow of data from asset level up through the portfolio, making scenario modelling that much more challenging, which in turn can discourage their use.

Disparate data sources

Modelling and analysis rely on getting information from disparate data sources via manual input, which takes time and is prone to human error.

Insufficient data sets

Investment teams often lack access to the rich, broad and deep data sets required for meaningful analysis, which undermines the rationale of that analysis and the value of its output.

Bias

Individual bias is deeply — and often invisibly — interwoven into the models, influencing the decision-making process and potentially leading to suboptimal results and an inappropriate allocation of capital.

Failure to "complete the loop"

This occurs when actual asset performance isn't fed back into the model that justified the acquisition in the first place, although it could improve future forecasts.

Erroneous data and/or modelling assumptions

Empirical evidence from data-cleansing projects suggests that, even where enterprise systems (as opposed to spreadsheets) are used to build cashflow models, up to one in five of these models contain significant errors.

Market direction

With advances in computing power, increasing access to both enterprise and external data, and growing interest in better ways to manage real estate investment risks, new classes of asset and portfolio modelling tools are emerging. The concept of FLI can be applied to a range of familiar analytical activities, including cashflow forecasting, valuations, hold/sell analysis, scenario modelling, sensitivity analysis and budgeting/re-forecasting.

Some of the applications deployed to exploit FLI are sophisticated "enterprise-grade" planning tools that investment organisations might already be using elsewhere in their enterprises to help manage other asset classes.

Others are modelling packages built specifically to manage real estate risk from both a debt and equity perspective. Some of these use statistical modelling engines, capable of taking into account decades of micro- and macroeconomic data that can model not just one or three scenarios, but literally thousands. These solutions also provide additional levels of insight into volatility at the asset and portfolio levels, as well as the shape of the risk curve depending on numerous variables — all of which support better investment and investment decisions.

As the emphasis shifts from backward- to forward-looking information, organisations see benefits not only in managing investment risk, but also in:

- Improving performance, as better information and analytical capabilities lead to more informed decision-making.
- Increasing operational efficiency, as more automation reduces manual work and the associated errors, allowing a greater focus on driving deal performance.

Potential challenges

While it is reassuring to know that for the next generation, forward-looking modelling tools are becoming available to real estate investors, their use in this asset class is still in its infancy. And, however sophisticated these nascent systems may be, they all rely on consistent, complete and accurate asset-level data. It is therefore more important than ever to have a strategy, tools, processes and governance to acquire and maintain that data.

Finally, a cultural change is sometimes required: investment management professionals need to both understand and embrace the use of these tools — it should no longer be acceptable when making critical investment decisions to trust "gut feelings."

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CORPORATE OVERVIEW

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