Opco/Propcos – structurally unsound?

Jamie Hyams considers whether the financial crisis has undermined the foundations of Opco/Propco structures or whether anything can be salvaged from the rubble.

Before the current lending crisis it was not uncommon for companies with good real estate portfolios to look at alternative ways of leveraging their assets to raise finance. Often the trend was to move away from traditional methods of charging property in order to increase the level of borrowing available or improve the terms on offer. One popular method was to transfer the property ownership to one group company (Propco) and retain the operating business in another (Opco). By financing each separately a group could, in theory, raise more and/or cheaper debt.

**Structure**

The basic Opco/Propco structure operates by way of a sale and leaseback process. Opco sells the real estate to Propco for cash and Propco then leases the real estate back to Opco on an institutional long lease. Opco and Propco are independent of each other and may even become separately owned. The objective is to release capital that is locked up in real estate assets so it can be redeployed in the operating business.

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The following diagram shows a typical Opco/Propco structure:

Opco/Propco structures are usually used where the group wants to retain ownership and control of its real estate. This differs from traditional sale and leaseback transactions, where the property is sold to an independent real estate investor and the former owner becomes the occupational tenant.
Increased Borrowing
Propco borrows against its new property assets and uses the rental income from Opco to service its debt. In return for the property, Opco obtains a capital sum that it can use in its business rather like a loan advance. Selling the properties to Propco does not materially reduce Opco’s borrowing capacity as lenders of business loans generally concentrate on the ability to service debt rather than comparing the amount of the loan to the value of balance sheet assets. This contrasts with Propco’s lenders who will usually look at Propco’s loan to value ratio. In theory, therefore, the Opco/Propco structure enables Opco and Propco to borrow independently of each other and raise more finance.

Property Issues
One of the key features of the Opco/Propco structure is that Propco is a clean, newly-formed company. Where leasehold properties are concerned, only long term premium leases (leases granted for a term of 50 years or more at a premium) are usually suitable, both for value and security reasons. A rack rent short term lease is generally unsuitable as it is regarded as a liability with no capital value. Where long term leases are available, they may still be unsuitable if landlord’s consent is needed to assign and if insolvency of Propco would enable the landlord to forfeit the lease.

Popularity of the Opco/Propco structure and the impact of the Global Financial Crisis
The reason for the popularity of the Opco/Propco structure before the current economic crisis began in 2007 was evident. The structure enabled companies to release equity caused by the property boom without selling the underlying assets and allowed Opco to fund further expansion. To maximise borrowing, the lease terms were heavily weighted in favour of Propco because both the property value and the borrowing capacity at Propco level depended on the terms of the underlying lease. Lenders competed to provide finance secured against such assets whilst investors fought to acquire long term, secure income streams which increased through upwards-only rent review or ratcheted/fixed rent mechanisms.
However, the prevailing confidence that the yield compression could continue without correction proved misplaced as the market peaked and started falling. The pressure on pricing finally imploded with a massive fall in capital prices exacerbated by the credit crunch which saw full-scale withdrawal of liquidity from the markets.

The Global Financial Crisis also took hold at Opco level. The rigid lease terms that Opco faced as tenant plus the sale of its prime assets left Opco exposed to an insolvency risk if it could not continue to trade. Many UK businesses that utilised the model - pub groups (such as Barracuda, Orchid), care home groups (such as Southern Cross, General Healthcare Group) and car parks – found themselves squeezed at Opco level. The reduction in government spending was reflected by local authorities who reduced spending on procuring beds in private care homes, resulting in lower occupancy rates. For Southern Cross, the impact eventually forced it to wind down and hand the homes back to its landlords. Pubs also faced challenges from discount retailing by supermarkets and reduced trade caused by the smoking ban.¹

Opco/Propcos – when it all goes wrong

The downturn in the economy resulted in Propcos owning devalued assets which breached the terms of their loan to value covenants whilst the ability to service their debt from the Opco income stream looked more fragile. Many Opco tenants meanwhile struggled to meet their rent payments as in the case of Southern Cross where the high rental levels became unsustainable and its ability to operate as a going concern became threatened. Given the sensitive nature of the business, there was considerable public outrage at the prospect of the closure of care homes and Southern Cross were criticised for taking financial risks.

Mitigating the Risks

It is understandable that, in the aftermath of Southern Cross and the credit crunch, Opco/Propco structures have become increasingly rare. However, they should not be written off entirely. Greater care needs to be taken and an increased emphasis placed on mitigating the risk to Opco without significantly reducing the value or debt capacity of Propco. There are a number of ways to do this:

- Leases that have stepped or index-linked rent increases may cause cash flow problems when the operating business struggles so they should not be agreed without proper consideration. Shareholders in Propco will want to maximise returns by imposing high rents, but this should not result in Opco becoming so vulnerable that the entire business could become insolvent as a consequence.

- Opco should retain the sales proceeds until there is evidence of sufficient growth in operating cash. This retention mechanism may be perceived as an inefficient use of the restructured capital, but ultimately it can be a prudent safety net in the event that the operating business experiences reduced revenues.

- Where there is a portfolio of properties, a piecemeal transfer of properties to Propco may be advisable so that only those assets that have been fully operational for a specified time are transferred and the group can ensure that the Opco owns tangible assets.

The future of Opco/Propco

The prospect of Opco/Propco structures becoming more popular in the near future is unlikely. The continuing lack of available credit leads to an additional issue: many of the companies that entered into Opco/Propco structures will shortly need to refinance their loans if they do not already need to do so.

Some of these loans are for significant sums and the current lending market is unlikely to absorb them in any structure. Borrowers will therefore need to look at alternative markets to attract funding. Alternatively, an outright sale of the assets may be the only available solution, albeit a less attractive one for the original investors.

The fundamental principles behind the Opco/Propco structure are not the reason for its decline in popularity. The decline is directly attributable to the current lending
crisis and the negative criticism that such structures have received. As ever, the press will only report those instances where the Opco/Propco has gone wrong rather than its successes, of which there are undoubtedly some.

Mistakes have also been made at board level, but lessons can and should be learned. If and when the current lending crisis eases, Opco/Propco structures should be looked at again as a way of releasing capital. Provided they are operated sensibly, Opco/Propco structures can be a viable way for companies to realise value in their assets whilst retaining ownership of them.

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1 Which came into force in July 2007.