

OpCo-PropCo: A Redundant Technique or Here To Stay?

London, 21 November 2011, by Arjan van Bussel and Amir Khan

Historically, sale and leaseback transactions have proven to be an effective and competitive way to finance acquisitions and to refinance companies that own real estate. In its traditional form, a company would sell its properties on an outright basis before leasing it back. In the early 2000s, companies began to move away from this traditional method in favour of the so-called OpCo-PropCo structure in which real estate would be leveraged without selling it. The financial crisis has exposed challenges in OpCo-PropCo transactions, the most important one being refinancing. In this article, we evaluate the once popular real estate monetisation technique and explore what options exist to meet the OpCo-PropCo refinancing challenge.

Introduction

In any sale and leaseback transaction (both traditional and OpCo-PropCo) the property assets are first separated from a company's operating business. Often, two legal entities are created, one housing the properties (the PropCo) and the other the operating business (the OpCo). Leases are put in place between the PropCo, as landlord, and the OpCo, as tenant. In a traditional sale and lease back transaction, the PropCo is sold to a third party.

The OpCo-PropCo variant was used extensively during the 2004-2007 property boom. For companies, it allowed the raising of real estate backed funding without diluting their control at operational or property management level. The corporate retains freehold ownership of the asset and the real estate remains consolidated on the balance sheet.

The PropCo is typically financed in the bank market by a mortgage loan secured by the property and the associated lease agreement whereas the OpCo can have a separate corporate-style debt facility (working capital, capex etc.). In the pre-crisis days, banks often repackaged the PropCo

loan into a CMBS transaction for institutional bond investors.

The value game in corporate real estate disposals

Although separation of the property and operating assets is a zero-sum game from a cash flow standpoint – as one unit receives the rent that the other pays – it may not necessarily be so from a valuation perspective. In a booming real estate market, the value of a corporate's properties typically becomes an increasingly large proportion of the value of the corporate as a whole, and sometimes even exceeds the overall value of the corporate. This situation is usually driven by (i) compressions in rental yields resulting in increasing property values and (ii) availability of leverage enabling financing of higher PropCo values. Relative value buyers, such as some private equity houses, will spot such an "arbitrage" opportunity and seek to acquire the corporate and then finance this acquisition via an OpCo-PropCo structure. This phenomenon was witnessed between 2004 and early 2007. Yields across Europe reduced on a year-on-year basis in the retail, industrial and office sectors and investors, in their hunt for yield, were actively seeking investment

opportunities in less liquid, more specialised real estate assets. Additionally, there was an abundance of debt financing, a feature that was further encouraged by a rapidly expanding CMBS market. Unsurprisingly, this period witnessed a sharp increase in the number of OpCo-PropCo structures being implemented on the back of specialised asset classes, such as healthcare and nursing homes. A good example, where both the OpCo and the PropCo were sold, is the transaction in 2007 where the operating business of Avalon Care Homes was sold to BUPA and the properties to Prudential. However, there is also the infamous example of the Southern Cross Healthcare (SCH) transaction, whose demise in 2011 exposed the specific and broader risks entered into during the OpCo-PropCo boom.

SCH became one of the largest care home companies in the UK over a period that witnessed its corporate reorganisation in the form of combining nursing homes businesses, disposing of properties and floating the operating businesses. But as part of its financing package, SCH had committed to future ongoing contractual annual rent increases. Figure 1 shows how increases in SCH's rents caused, after 2009, a sharp narrowing of the gap between operating cash (before meeting rent, other financial payments and investment needs) and rent payable. The company's high operating leverage as a consequence of its lease terms was exposed in a period of declining revenues. The considerable cash and profitability squeeze, due to lower-than-predicted operating cash before rent, resulted in the rent levels becoming unsustainable and the company's ability to operate as a going concern threatened. Given the sensitive nature of the business – caring for the elderly – there was considerable public

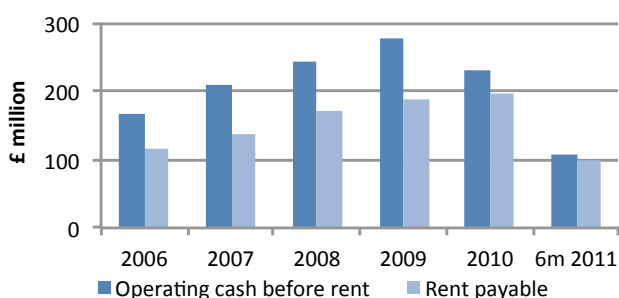
outrage on the prospect of closure of SCH and why a company in such a sensitive sector could have entered into such financial risks. A major restructuring is presently underway that will see the transfer of care homes to new operators under revised lease terms.

The situation at SCH, UK's leading care home company, that will cease to exist by the end of 2011, has delivered many important lessons about the application of OpCo-PropCo structures. Leases that have rents rising (either fixed or inflation-linked) may cause cash flow problems when the operating business struggles. Stringent lease terms can also be viewed as a value transfer from the OpCo to the PropCo.

Shareholders' desire to maximise returns is understandable but in our opinion should not result in an OpCo becoming so vulnerable that it could be put out of business as a consequence of an aggressive financing structure. At Bishopsfield Capital Partners, we think there is still a place for OpCo PropCo structures but emphasis needs to be put on mitigating putting OpCos at risk without significantly reducing the value, or debt capacity, of PropCo. For example:

- *Retention of sale proceeds in OpCo:* The OpCo could retain a certain amount of the sale proceeds until there is evidence of sufficient growth in operating cash. Although this retention mechanism can be perceived as an inefficient use of available capital, it can prove to be a prudent governance measure in providing a safety net to the OpCo in case the business deteriorates.
- *Piecemeal transfer of properties to PropCo:* Properties that are fully developed but whose underlying businesses are still in the process of ramping up could be retained by the OpCo. Transferring such properties at an early stage to the PropCo may not deliver the best value, due to uncertainties around the associated operating business. By only transferring those assets that have been fully operational

Figure 1: Southern Cross Healthcare Operating Cash profile



Source: Southern Cross Healthcare Annual Reports

for a certain minimum period of time, the company would ensure that the OpCo owns tangible assets. This allows the OpCo to raise financing independently to drive growth or provide security if and when the operating performance stutters.

These are just two examples of how financial risks can be mitigated when implementing OpCo-PropCo structures. Similar features might be required when refinancing outstanding secured PropCo loans.

Refinancing challenge for OpCo-PropCo structures

Following the credit crisis, commercial property yields have risen, values have declined, and the regulatory regime around capital and liquidity buffers for banks has become much more stringent. Consequently, refinancing real estate loans is challenging and even more so for loans that are collateralised by specialised, operational assets with limited alternative use. Additionally, the size of many pre-crisis PropCo loans is problematic. The post-crisis bank market is not deep enough to absorb large-sized loans on a bilateral or club basis and banks are also reluctant to underwrite these loans for subsequent syndication.

Table 1: Market capacity for refinancing an OpCo-PropCo structure

	Financing Pre-Crisis (1)	Refinancing in Current Market (2)
Operating Cash before Rent	90	105
Rent Coverage	1.5	1.75
Rent	60	60
Rental yield	6.0%	8.0%
Property value	1,000	750
Loan-to-Value	80%	60%
Loan	800	450
Funding gap (1) - (2)		350

The market capacity for a refinancing under an OpCo-PropCo structure is driven by factors unrelated to the OpCo business, such as higher required rent coverage, wider rental yields and a more conservative LTV requirement. Table 1 illustrates a refinancing scenario for a PropCo that was financed pre-crisis where despite an

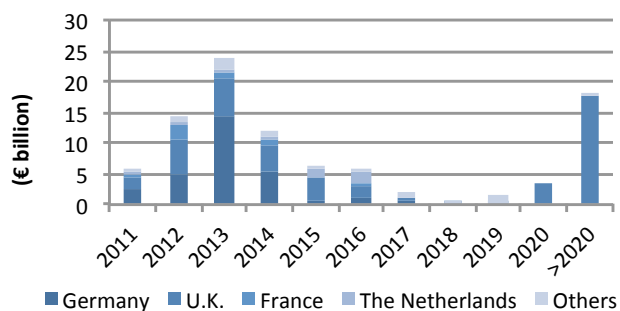
increase in annual operating cash before rent (105), the higher required rent coverage (1.75) results in the same level of rent (60) as in the pre-crisis scenario. The refinancing capacity then becomes a function of the rental yield and LTV, where rental yields reflect the returns required by property investors for a particular asset class and LTV is a function of lenders' appetite.

Unfortunately, the European CMBS market, previously used actively by banks as a means to downsell their real estate lending exposure, ground to a halt in 2007 and has remained effectively closed since then. From 2008 to mid-2011, the only CMBS that has been brought to the market is the EUR 350 million tap-issuance of Vesteda, the Dutch real estate fund, and that was an exceptional case given its conservative LTV and highly granular asset portfolio exclusively in the residential sector. The June 2011 issuance of the £302.2 million Deco-2011 Chiswick Park transaction was another welcome and brave attempt to open the primary European CMBS market. Both transactions were significant in their own right but neither caused a flurry of follow-on CMBS issuance.

The CMBS market has its own refinancing problems. The bulk of securitised loans were originated during the boom that lasted from 2005 to the middle of 2007 and this has led to a €50 billion refinancing challenge for 2012-2014 (see figure 2). When considering how the market will absorb these refinancing obligations, it is important to look at the maturity performance of the CMBS loans by reported LTVs. As figure 3 illustrates, a significant number of securitised loans with modest LTVs have been successfully refinanced, but this success rate decreases rapidly with increasing LTV levels.

In this context, it should be noted that the LTV of CMBS notes is typically lower than the advance rate of the underlying loans that back these notes: the balance was funded through junior pieces or "B-notes" sold to specialist funds. It will come as no surprise that the B-note market too has been severely affected by the financial crisis and even if the CMBS market staged a recovery, the vacuum created by the absence of the B-note investor base will still pose a difficulty. In more typical cir-

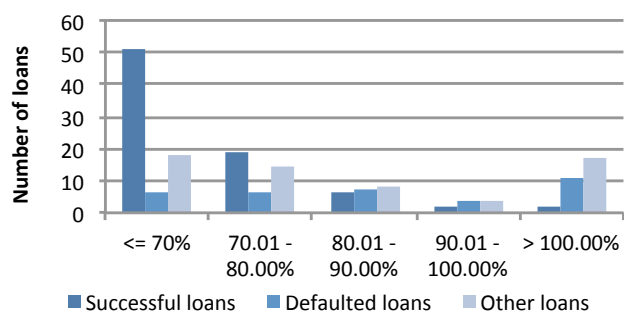
Figure 2: Maturity Profile for CMBS* Loans, outstanding balance



Source: Standard and Poor's

*Excludes commercial real estate collateralized debt obligations, non-performing loan transactions, and small borrower transactions. Includes loans denominated in pound sterling, which are converted into euro.

Figure 3: CMBS loans maturity performance by Reported LTVs (Jan 2010 - Sep 2011)



Source: Standard and Poor's

cumstances, a B-note would have been an obvious instrument to fill part of the funding gap.

Refinancing options for OpCo-PropCo transactions

Refinancing options for OpCo-PropCo transactions should not be construed as implying structural weakness of these property-backed structures. With banks unlikely to entirely absorb the PropCo loans that need to be refinanced, coupled with the absence of a vibrant CMBS and B-note investor base, borrowers will need to look at alternative markets to attract funding. It is doubtful that insurance companies, which are currently carefully entering the real estate lending market, will be willing or able to provide sufficient funding to refinance outstanding PropCo loans. Instead, we believe that borrowers will have to look at alternative investor sources with different risk profiles. Does this suggest that the OpCo-PropCo mechanism has lost its credibility completely? We believe it has not. There are no challenge-free solutions, but alternative financing structures can offer refinancing solutions that are more acceptable in the current market environment and also attract a new investor base that may be keen to increase exposure in certain sectors. We set out examples below:

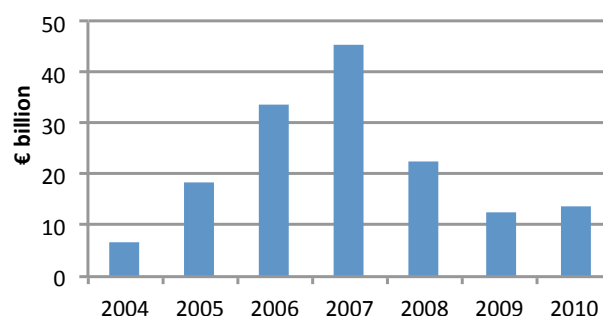
Outright sale of corporate real estate assets

Outright sale of property assets is likely to yield proceeds greater than what may be possible in an OpCo-PropCo refinancing because the latter only finances part of the property value, as stipulated by the LTV requirements. Consequently, the sale

of property assets has been popular in recent years particularly in the area of retail/supermarkets and also sectors including hotels and leisure. Pension funds have been keen investors looking for attractive long-term yields on the back of robust portfolios and sound operating business profile. Figure 4 shows that the value of the properties actually sold by owners, who are also occupiers, has decreased substantially during the current crisis. However, corporate real estate sales in Europe totalled €14 billion in 2010 which still boasts a material amount of liquidity. Market developments such as FIDAC, the UK-based subsidiary of US REIT Annaly Capital Management, hiring Northcliffe's entire management team for a planned expansion in the pan-European sale and leaseback market is a good example of the potential interest.

Outright sale of real estate assets remains promising for liquid and high quality assets. However, we believe that less liquid or more specialised real estate assets will attract less traction in

Figure 4: Owner-Occupier Sales in Europe (Volume)



Source: CB Richard Ellis, 2H 2010

today's market and an outright sale of such properties, or the related property owning company, might therefore not be an attractive proposition for those asset types.

Whole Business Securitisation transactions

At a time when we see convergence to secured transactions, even for some of the most credit-worthy names, Whole Business Securitisations (WBS) cannot be ignored. In the UK, WBS has been a tested product in a variety of sectors including pubs, leisure, utilities and healthcare. Investors benefit from ring-fencing of the "whole" business as opposed to a certain part, such as properties. The debt capacity analysis is therefore performed on the projected cash flow profile of the entire business and is not influenced by extraneous factors such as property yields. Unlike an OpCo-PropCo transaction involving a bank loan that could be pooled, tranching and rated via CMBS, a WBS is structured as a normal, albeit secured, bond issue.

The pursuit of secured structures, such as WBS, could trigger collapse of the OpCo-PropCo security structures resulting in creation of a single ring-fenced business entity. We believe that sectors demonstrating stable business characteristics (for example, healthcare) can be suitable candidates for a WBS. Furthermore, an enhanced security package coupled with an inherently stable business profile will help maximise leverage and tenors.

Credit Tenant Lease transactions

Of a hybrid nature similar to WBS, are transactions commonly referred to as Credit Tenant Lease (CTL) deals. The main characteristic of a CTL transaction is that there is no true real estate exposure – it is a securitisation of rental payments with the notes being scheduled to fully amortise during the term of the transaction. The real estate security is just an add-on. Not only is there no refinancing risk, but with the leases being on fully repairing and insuring terms, the tenant is responsible for maintenance and payment of insurance premiums. Furthermore, the tenant is typically obliged to make rental payments regardless of any damage or destruction to the properties, even if the tenant is prevented

from using them.

As demonstrated by four Tesco transactions issued between June 2009 and February 2011, and also by the Sceptre Funding transaction in July 2009 with the UK government as tenant, there remains appetite from investors for long-term, credit linked transactions with investment grade tenants.

Conclusion

Funding gaps will require stakeholders in OpCo-PropCo structures to suffer pain; the question is how much and can it be eased? The question of how much will be a function of the market capacity under different structures available, such as an outright property sale, WBS and CTL transaction. Property investors could stand to benefit if companies look to sell prime real estate to raise financing. In terms of easing the pain for lenders, unfortunately, there will not be any quick fixes. Lenders have a choice of accepting either a maturity extension altogether or a refinancing that reduces exposure partially with the balance rolled into a quasi-equity position. In both cases, the underlying strength and future prospects of the operating business will drive the decision. If the business cannot access the market when a refinancing is due, a maturity extension may be the only feasible option. However, achieving this may not be very simple for securitised loans as the interests of different classes of noteholders may not be fully aligned. Foreclosure always remains the least desirable option and in cases involving properties with limited alternative use, this may not be a sensible strategy for lenders.

In today's market, we believe OpCo-PropCo financing is likely to continue to struggle in the short term due to factors such as (i) the current state of the bank and CMBS market (liquidity problems); (ii) a material reduction in property valuations (yield widening); and (iii) the inadequacy of cash flows to meet rental obligations (economic recession). But none of these factors expose an inherent weakness in the OpCo-PropCo structure and therefore, does not dislodge its important positioning in the sale and lease-back financing universe. Replacement of legacy OpCo-PropCo structures with a new instrument

is, therefore, less a function of the underlying OpCo-PropCo model but more influenced by the situation where the European property financing market and the global economy find itself in at the moment.

If you agree with our views in this Market Insight, and even if you don't, we would be delighted to hear from you (info@bishopsfieldcapital.com).

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