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Hotel Financing Series, Part 3: Use of OpCo/PropCo Structures

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In this part 3 of our hotel financing series, we discuss one of the most common structures – the “OpCo/PropCo” structure – and some of the issues surrounding security as a result of this structure.

The OpCo/PropCo structure comprises two special purpose vehicles, a PropCo (*i.e.*, property company), which holds the real estate interests of the hotel, and an OpCo (*i.e.,* operational company), which holds all other assets of the hotel, such as rights to key hotel contracts, licences, etc. and is essentially the trading company. PropCo leases the property to OpCo, and OpCo pays rent to PropCo under the lease and operates the property as a hotel. OpCo may undertake the hotel management duties, but often this is outsourced to a professional hotel operating manager. The hotel operating manager and OpCo deal with the franchisor with respect to the franchise agreement and hotel operating licence.

There are several reasons why this is a popular structure in hotel financings. Firstly, the separation of the real estate asset (held by PropCo) from the rest of the trading business (held by OpCo) segregates the ownership of the different types of assets and allows the owners to ring-fence the associated cashflows. This then makes it possible for the loan to be provided to PropCo as the principal borrower and secured against the real estate interest, relying on a fixed cashflow stream (being the rent from the operating lease), and therefore achieving more attractive commercial mortgage terms as opposed to leveraged finance.

That being said, with OpCo and PropCo in the same group, and the source of funds to pay the rent for the operating lease coming from the income of the hotel, lenders will (and should) look at underlying performance and management of the hotel. Lenders are likely to require OpCo to also be a guarantor and obligor and grant security.

There are also other benefits to this structure, not least the fact that exit is cleaner with separate companies holding the different assets, and certain structures may also be beneficial from a tax perspective. In a previous **article,** we have discussed this in more detail. The cashflow structure is often tiered as a result of the split between PropCo and OpCo. A very common structure would involve the hotel manager (sometimes this could be OpCo, but often a designated professional manager) running the day-to-day accounts of the hotel, which collects all revenues and also attends to day-to-day expenses like suppliers, utilities and staffing costs. The gross profit (sometimes known as the "owner's return"), usually after deducting management fees and sometimes any fees payable to the franchisor, is paid to OpCo. OpCo will need to allocate the gross profit across a few items, amongst them: 1) rent to PropCo for the lease of the hotel property, 2) capital expenditure reserve for upcoming renovations and maintenance of the hotel and 3) payment of dividends and/or repayment of any equity injection to the Sponsor. Once the rent is paid to PropCo, PropCo then pays debt service/interest (as applicable) from its account. As mentioned above, although the rent is “fixed” under the lease, it is nevertheless dependent on the performance of the hotel (*i.e.*, if the business doesn’t perform, OpCo will not have the rent to pay PropCo) and therefore lenders often take security over every member within the group.

This will typically include share security over both OpCo and PropCo's shares, security over bank accounts, mortgage over the real property, all the contracts (*i.e.*, ground lease, the operating lease between OpCo and PropCo, any occupational leases, the hotel management agreement, and the franchise agreement) and any intragroup debt, especially if there were any sale and leaseback arrangements in place. This is to ensure any intragroup debt can be expunged upon enforcement.

Furthermore, the cashflow structure and payments waterfall out of the various accounts is usually one of the most negotiated items. It is important to balance the lender's requirement to have access and control over the cash to ensure all payments due under the facility is paid against the borrower's need to retain sufficient flexibility to make payments required to run its business. This is discussed in more detail in a later part of this series, where we look into each of the cash items in more detail.