CADWALADER

The Benefits of Opco/Propco Financing

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Across the real estate industry, "Opco/Propco" structures continue to be used as a method of raising debt against the real estate assets of a business. This article discusses key issues that a lender should look at in its credit assessment and potential exit strategies when considering Opco/Propco financings.

The classic Opco/Propco structure involves an operating business ("Opco") transferring ownership of its real estate assets to a special purpose property holding vehicle ("Propco"). The model was largely pioneered by private equity and investment banks as a way of raising cheaper debt in acquisition financing structures and is often used by hotel groups.

By essentially transferring the real estate assets of the operational business into a newly formed special purpose property holding structure with leasebacks in place, owners can create ring-fenced cashflows which can be secured over that real estate to achieve significantly more attractive commercial mortgage terms as opposed to more expensive leveraged finance.

Over the last 20 years, the appetite amongst borrowers and lenders for sale and leaseback transactions and ground rent schemes has been very significant.

Some of the typical advantages of the Opco/Propco structure include:

1. Ring-fenced mortgage deals are workable within commercial mortgage departments of banks and compatible to covered bond structures such as *Pfandbrief*. The risk profile and thus the cost of debt is significantly lower as the leverage is entirely different – typically, a fully collateralised mortgage on a 60% Loan to Value Covenant deal with the income servicing the loan (essentially, the lease rent under the sale and leaseback arrangements) being prioritised.
2. The trading business releases value in capital assets.
3. There may be tax advantages – holding property in an offshore vehicle may permit transfers of the shares in PropCo to be made free from UK registration duties (neither stamp duty land tax nor stamp duty applies to transfers of shares in an offshore Propco, at least under current UK tax law).
4. VAT planning is sometimes easier with an Opco/Propco structure because the grant of an intra-group lease may allow Propco to recover VAT.

As with any structure, the method of the structure’s original construction and how it fares when it is unwound for a potential sale are highly significant. This is the case not only for the borrower but also the lender, given that the credit assessment of such a loan will require (or should require) legal due diligence being undertaken on the effects of any enforcement of security.

Lenders should therefore focus early on the intra-group lease structure/post-sale re-organisation which would be required to effect the Opco/Propco split. In particular:

- How do the cash flows work? Is the equity for the financing subject to related transactions around the sale of the business? What protective measures are needed when debt is advanced?
- Is sufficient and effective security being granted over the entire sale and leaseback arrangement and group so that the lender has options on enforcement? Can the lease be terminated or amended by the lender so that it can be repackaged for exit?
- Are cash flows and intra-group lending arrangements fully secured so that intra-group liabilities can be expunged by the lenders?

- Has appropriate tax analysis been undertaken in conjunction with the structuring, and what are the tax ramifications of unwinding the structure?
- What are the effects of splitting the group on enforcement in relation to any intra-group reliefs utilised during the re-organisation period? For instance, can a revenue authority claw back taxes in situations where the vehicle to which the property was transferred leaves the group?
- Can revenue authority challenge relief applied for around the re-organisation period, or is the relief applied for just process?
- How have capital gains tax ("CGT") liabilities been dealt with within the group? We would refer you to our **tax article** in the first edition of *REF News and Views* which dealt with the UK's new non-residents capital gains tax regime. On any enforcement sale, Propco may be liable for any CGT in respect of the property, and the lenders may look to exit via a sale of the property and leave the CGT liability with Propco. So, essentially, the lenders' enforcement options are more limited – the sale of shares in the Propco being unlikely unless the CGT liability is something the purchaser is willing to take. Suffice it to say it does not automatically follow that the property will have dropped so considerably in value at the time of enforcement that all CGT liability is extinguished.

The above matters are all considerations that a prudent lender would wish to take, as they could affect the cash flow front end of the deal and any enforcement. Clearly, a number of these scenarios will be more relevant than others depending on whether the preferred exit strategy is a sale of the real estate or an indirect sale (the Propco). In situations where there is a genuine risk of a clawback, the lender may wish, on a case-by-case basis, to have discussions with the borrower as to retentions or other options.