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PropCo

While researching Caesars, operator of casinos and hotels, we stumbled across an interesting real estate investment concept related to PropCo, or an abbreviation for property company. Per Investopedia, "Propcos are most often used to describe a subsidiary company that exists to hold or own a parent or operating company's income-generating real estate. The property company owns all of the real estate and related debt, providing the parent or operating company with advantages related to financing and credit rating issues."

By creating a separate Propco, the holding co. can de-lever the operating co. (Opco). With the same assets, two separate subsidiary entities are formed. But what advantage does this corporate structuring have over a single entity Opco? There is assumedly more paperwork involved with 2 entities filing paperwork.

One advantage is the lower leverage can allow the Opco to borrow more money at favorable terms, especially if the real estate related debt, is high. Normally, mortgages are not included in the financials for companies. However, banks would take into consideration high LTV when underwriting a loan.

Another advantage is the sale/leaseback agreement between the two entities allows the Opco to receive a large sum of capital at once, while the Propco could finance the newly purchased property through collateralized debt, through instruments like CMBS, or a simpler bank loan. Propco would have to remit periodic principal and interest to the CMBS investors, or the bank, and will finance the remittance through the lease payments from Opco. Typically, there will be a positive Net interest margin, or the lease payments will be higher than the P&I payment to the investors.

The advantage was found before the real estate bubble burst in 2007. The structure allowed companies to unlock the equity in their real estate without selling the properties to third parties. A critical piece of the sale/leaseback agreement was high historical rates locked for a long period of time, often many years. The author of an article found at Lexology explained many UK companies which adopted the Opco/Propco structure went out of business when the Opco was stuck with high lease payments in a weak economy. Also, the Propco was breaching covenants related to LTV when the value of the properties dipped and faced liquidity concerns as the Opco showed signs of stress in making timely lease payments.

Besides the liquidity issue related to Opco's performance, the inability to refinance the loan, or debt is another concern for Propco investors.

Related resources: http://www.lexology.com/library/detail.aspx?g=677186d6-0f94-4ad0-8af1-881c9060aefe