# OAK INVESTMENT MANAGEMENT GROUP

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*Often companies with large owned real estate split themselves into an Operational company (Opco) and a Property company (Propco). The former company, now Opco continues along the same line of business as it did hitherto, whereas the latter Propco collects rents from the operational company.*

The new Propco can either continue servicing the same Opco from which it came or can expand to analogous or diverse sub-sectors. The new Propco can either be held intra-Group or sold out. Either way, the sub-division of a business into two distinct groups has profound implications.

In an economically frictionless world, the two entities would be competing in a zero sum game. Cash is generated by the operational company with client or retail facing revenues, and rent is a charge on that same cashflow. An Opco by definition should seek to minimise this rent, and a Propco by definition should seek to maximise this rent. As soon as the bottom line is separated, interests as constituted (even if the ownership is exactly the same for both vehicles) are not aligned.

Nevertheless, the world is full of frictions. For a start, accounting and tax implications mean that governments treat operational and property companies slightly differently. This opens up a host of opportunities that a pure play operational or real estate company can exploit when they are free of each other. By the by, because it is so counter-intuitive, there are some aspects of real estate that can be much more transferrable to other jurisdictions than operational companies.

The market is not free from its own biases. Because rent is an important call on free cash flow (it is higher up the P&L) it is considered less at risk *per se*, than the profits emanating from that same business. For larger companies their wholly owned Propcos can trade at a significant (and varied) premium to the underlying Opco. This empirical evidence cannot be supported by any variant of 'efficient market hypothesis' so the market's persistent behaviour can be classed as 'irrational.'

The initial sub-division into Propco and Opco is fraught with difficulties, because the level of risk absorbed by each business is hard to ascertain. However, once the initial division is made between Propco and Opco i.e. there is a sustainable and fair rent (from Propco's prespective) and there is an affordable level ascertained (from Opco's perspective) this allows each to concentrate on its core competence. It is self-evident, that if you run a successful Opco your resources should not be tied up in real estate, and *vice versa*. The one demonstrable exception is an entity with huge bulk, but razor thin margins. That model might require an installed asset base as a survival mechanism and a 'normalising' factor that allows it to survive to the next iteration of the 'fight'.

As a manager, the rationale of calling into being a Propco and an Opco is not a scientific method but rather positioning of strategy. This involves management weighing up first, the accounting and tax implications of the move; secondly, the market perception of the underlying business going from one to two distinct pieces; and thirdly, the fundamental benefits of focus to each business. These decisions should not be taken lightly as they are largely irreversible and, just like debt, the consequences are very long lived indeed.

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