

Fitch: REIT 30-Year Issuance A Net Credit Positive

Written by Australian Business

NEW YORK--([BUSINESS WIRE](#))--Liquidity benefits derived from 30-year issuance, combined with the enhanced visibility of interest costs as interest rates remain near historical lows, are generally viewed as a credit positive, according to Fitch Ratings. These positive elements are balanced by an increase in the asset/liability duration mismatch and the "unknown unknowns" that could arise from saddling the next generation of management with current REIT covenants.

Over the last nine months, two U.S. REITs have issued 30-year unsecured bonds. In June, Equity Residential Inc. sold \$750 million of senior unsecured notes due in 2044 at a 115 bp spread to the benchmark Treasury rate. Last September, Ventas Inc. issued \$300 million of 5.70% senior unsecured notes due 2043 at a 195 bp spread to the benchmark rate.

Issuing 30-year debt improves a REIT's debt maturity ladder by reducing the percentage of debt maturing over the rating horizon (typically three to five years), assuming constant leverage. Fitch views term (maturity), rather than payment, as the principal risk to REIT credits given the constraints on cash flow retention inherent in the REIT model, viewed against generally stable cash flows for most REITs, which often benefit from long-term leases to well-capitalized tenants.

Long-duration, fixed-rate debt also improves a REIT's interest-cost visibility. Interest is typically the largest recurring cost for REITs, somewhat analogous to cost of goods sold for traditional corporate industrial issuers. Improved visibility on a significant component of a REIT's cost structure should aid in its ability to plan and execute its strategy.

However, 30-year maturities extend well beyond even the longest lease terms for REIT assets, save for select retail anchor-tenant leases with extension options. Issuing such long-term debt can increase the duration gap between a REIT's assets (defined as weighted average lease term) and its liabilities (weighted average maturity), potentially exposing a REIT to greater cash flow volatility based on changes in inflation and interest and rental rates. This duration mismatch can be particularly acute for short-duration property types, such as hotels, apartments, self-storage and industrial, which generally have shorter weighted-average lease terms ranging between nightly for hotels and three to five years for industrial.

A deflationary U.S. economic scenario would likely pressure rental rates and REIT cash flows. Managing balance sheets to a narrower duration gap would allow for a repricing of a REIT's liabilities to help offset the decline in cash flows under such a scenario. Prepayment or "make whole" penalties would likely make retiring a 30-year bond ahead of maturity prohibitively expensive.

Burdening the future generation of a REIT's management with current covenants could cause unforeseen consequences. Items such as operating strategies and accounting definitions can change over time, perhaps in ways not contemplated by existing covenants. Some of the first REIT unsecured bond indentures in the early 1990s failed to consider that accounting definitions can change, resulting in expensive consent solicitations for some REITs to adjust EBITDA definitions to exclude noncash charges, as one example. Certainly the flexibility has improved as REIT bond indentures have evolved. Nevertheless, even the most thoughtfully written indentures today could cause unintended consequences down the road.

Some forms of long-term financing obligations are more desirable than others. For example, Fitch views the so-called 30-year "baby bonds" issued by Ventas favorably due to the imbedded call optionality after a five-year period.

Fitch also treats REIT preferred stock as 100% equity for leverage purposes given the perpetual nature of the obligations and the inability of dividend nonpayment to trigger corporate default. Perpetual capital is clearly advantageous in the context of REIT tax regulations that limit the ability for REITs to retain internally generated cash flows, which requires REITs to have consistent access to the capital to satisfy debt maturities. We also view the standard five-year call optionality imbedded in REIT preferreds as an attractive risk mitigant in case interest rates unexpectedly decline from current low levels.

The above article originally appeared as a post on the Fitch Wire credit market commentary page. The original article can be accessed at www.fitchratings.com. All opinions expressed are those of Fitch Ratings.

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