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REITS and Financial Covenants: A Delicate Balance

*Pauline M. Stevens**

This article describes how the financial covenants imposed on real estate investment trusts ("REITs") differ from standard formulations used in other industries, recent variations in REIT agreements, and the effectiveness of these variations in achieving the goal of determining a REIT's financial condition in the current economic environmental.

Institutional lenders rely on financial covenants to help test the adequacy of borrowers' equity, earnings, and cash flow to pay their debts. Many financial covenants do a good job of providing lenders and borrowers with an appropriate understanding of the financial condition of borrowers. However, not all financial covenants have adequately performed their intended function during the recent economic downturn. Some financial covenants did not account for anomalies in economic patterns and caused creditworthy borrowers to default under their credit arrangements. Other financial covenants failed to trigger defaults before it was too late. Being particularly stressed by the financial crisis, the real estate industry's covenant structures have been extensively reconsidered over the last few years.

The job of restructuring financial covenants for the real estate industry in general has been particularly complicated in the case of real estate investment trusts ("REITs")[1] because the tax regime governing their business can impede application of financial covenant structures that otherwise might be workable. Based on financial covenants contained in recent filings by REITs with the United States Securities Exchange Commission,[2] this article describes how the financial covenants imposed on REITs differ from standard formulations used in other industries, recent variations in REIT agreements, and the effectiveness of these variations in achieving the goal of determining a REIT's financial condition in the current economic environmental.

Introduction

Some standard financial covenants applied to businesses in the real estate industry in general include a minimum net worth or tangible net worth test, a minimum fixed charge coverage ratio, and a maximum leverage ratio.[3] Typically, these covenants are calculated as of the end of each fiscal quarter on a consolidated basis in accordance with generally accepted accounting principles ("GAAP"). Basic definitions of these covenants would calculate revenue items for four

*Pauline M. Stevens is a partner in the Los Angeles office of Allen Matkins Leck Gamble Mallory & Natsis LLP and is a member of the firm's corporate group. She represents banks and other financial institutions in connection with a broad range of financial transactions, and can be reached at pstevens@allenmatkins.com. Tom Henning, Allen Walburn, and Julien Kern of Allen Matkins also contributed to this article.

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consecutive fiscal quarters and would determine balance sheet items based on financial statements as of the end of the fiscal quarter.[4] Broadly speaking, financial covenants being imposed on REITs recently follow a traditional pattern of assessing net worth or tangible net worth, fixed charge coverage ratios, and leverage ratios, but the methodologies for calculating these covenants sometimes vary significantly from the traditional methodology.

Net Worth and Tangible Net Worth Tests

A minimum net worth or tangible net worth test measures the corporate value of a borrower generally. A standard definition of "net worth" would subtract total liabilities on the balance sheet as of the end of a fiscal quarter from total assets as of the end of that fiscal quarter, all determined in accordance with GAAP. A standard definition of "tangible net worth" would subtract both total liabilities and intangible assets (including intellectual property, unamortized deferred charges and debt discount) from total assets. Frequently, the minimum consolidated net worth or tangible net worth that a borrower is required to maintain will increase over time based on future income or increases in shareholders' equity. In fact, recent agreements with a number of REITs contain fairly standard consolidated net worth or tangible net worth tests that are consistent with these traditional formulations, but other agreements make adjustments that are more sensitive to variables in determining real estate values generally.

Net Worth Tests Based On Income

In contrast to the traditional definitions of net worth and tangible net worth, some recent REIT financial covenants do not calculate net worth based on balance sheet items such as total assets and total liabilities. Instead, they calculate net worth by applying a capitalization rate to net operating income of a REIT for either four consecutive fiscal quarter or for a single fiscal quarter (which is multiplied by four). When this approach is used, tangible net worth would be the product of that calculation minus indebtedness. These covenants test the adequacy of a REIT's assets based on the ability of those assets to produce current income rather than relying on the historical book values reflected in a GAAP calculation.

Sometimes a REIT's net worth test that is calculated based on net operating income contains refinements reflective of the core business of the REIT. For example, lenders sometimes deduct from net operating income in these calculations income from sources that are not real estate[5] and apply different capitalization rates to stabilized and unstabilized real estate assets. Although these financial tests use the net operating income from real property as a proxy for value, raw land and real estate under development that are not yet income producing generally have been included in these net worth calculations on a GAAP basis. Since acquisitions of real estate assets during a fiscal quarter could contribute more to net worth than a pure calculation based on net operating income for that quarter might produce, adjustments might be made to these net worth covenants for acquisitions made during the relevant fiscal quarter, for example including them on a GAAP basis. Similarly, adjustments may be made for real estate assets disposed of during a fiscal quarter. Finally, tangible net worth tests calculated based on net operating income have been further adjusted by adding back to net income items such as management fees (which reduce net income without

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reducing the value of assets) and adding back cash and cash equivalents held on the balance sheet.

In some ways, calculating net worth or tangible net worth based on net operating income makes a lot of sense in an economic environment where GAAP calculations tell a lender little about the current value of a borrower's real estate assets and their ability to produce income, but calculations made on the basis of a single quarter, as opposed to four fiscal quarters, can magnify the effect of current performance (good or bad). When the calculation is made based on the performance of a single fiscal quarter, one good fiscal quarter could make a borrower look strong; one bad fiscal quarter could result in a default. As a result, calculations made based on performance in a single quarter take a short term look at a REIT's business, perhaps tiding it over until values reach a stable level that can be viewed as more indicative of the REIT's actual net worth or tangible net worth.

Future Equity Raises

As noted above, it is not uncommon for traditional net worth tests to provide for increases in the minimum net worth that a borrower is required to maintain based on a percentage of income or increases in shareholders' equity. For example, a borrower might be required to maintain a minimum net worth equal to a stated dollar amount plus, as of the end of each fiscal year, one-quarter of the net income for the year just ended. Because REITs are required to make annual distributions to equityholders of not less than 90% of their real estate investment trust taxable income to their equityholders in order to retain the tax benefits of being a REIT,[6] ratcheting up net worth requirements based on income could be a problem for REITs unless they pay distributions in equity.[7] In lieu of increasing the minimum net worth that a REIT is required to maintain based on income, some recent agreements require REITs to maintain a minimum net worth that is increased by a percentage of net cash proceeds received from future equity issuances. This approach generally works for REITs, because a REIT's net worth is increased by cash received in payment for new equity, and that cash is included in calculation of "real estate assets" to determine qualification as a REIT.[8] At the same time, lenders get the comfort that the value of their borrowers is being increased by cash investments pending employment in the real estate business.

Adjustment For Revaluations

A few traditional, balance sheet based net worth covenants imposed on REITs recently expressly deduct from net worth calculations write-ups (in excess of cost) in the book value of assets resulting from revaluations. GAAP would not presently permit these types of write-ups, but references to them in financial covenants reflect concern that balance sheet values could be inflated by the adoption by REITs of International Financial Reporting Standards ("IFRS")[9] instead of GAAP or by the convergence of GAAP with IFRS. What is sometimes called "fair value reporting" under IFRS will presumably receive attention in more REIT financial covenant calculations to the extent that GAAP appears to be moving in the direction of IFRS.[10]

Indebtedness Deducted

The definition of the "indebtedness" that is deducted in calculating traditional balance sheet based net worth or tangible net worth covenants for REITs generally includes:

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- obligations for borrowed money;
- obligations in respect of hedges;
- the deferred purchase price for assets;
- indebtedness secured by liens;
- capital leases;
- obligations to purchase or make payment on equity interests; and
- guarantees of the these items.

Not infrequently, however, this definition is being modified in REIT agreements to take into account the effect of financial products with particular importance in the real estate industry. For example, items such as non-recourse indebtedness in excess of the value of collateral and non-recourse carve-out guaranties (which provide that a non-recourse obligation will become a recourse obligation in the event of fraud, misappropriation, failure to maintain insurance, failure to pay taxes and the like) may be excluded from "indebtedness." But to the extent not included in "indebtedness" amounts payable on ground leases and contingent obligations to purchase assets, to advance funds, or to maintain working capital or equity are sometimes being added to "indebtedness" for purposes of net worth calculations.

Fixed Charge Coverage Ratio

A minimum fixed charge coverage ratio typically measures a borrower's ability to pay fixed charges by comparing earnings before taxes, interest, depreciation and amortization ("EBITDA") for four fiscal quarters with interest, lease, rental and other fixed costs or expenses paid or incurred during those four fiscal quarters. It is not uncommon in these ratios for EBITDA to be adjusted for items such as earnings and losses resulting from non-ordinary course of business activities such as asset dispositions. These adjustments attempt to normalize the EBITDA calculation to make sure that it is neither inflated nor reduced by non-recurring charges and income items that could produce aberrant calculations not responsive to the underlying goals of the financial covenant. While some REIT financial covenants do not stray far from a traditional fixed charge coverage ratio definition, a number of covenants recently have adjusted both the numerator (EBITDA) and the denominator (fixed charges) to take into consideration the particular details of REITs' assets and capital structures.

Adjustments to EBITDA

Not infrequently, reserves are being deduced from EBITDA in calculating fixed charge coverage ratios for REITs. Typically, these reserves are calculated based on the number of square feet of real estate assets held by a REIT as of the last day of the period for which EBITDA is being measured and provide a cushion in the fixed charge coverage ratio calculation for on-going required expenditures that might not otherwise reduce EBITDA. The reserve deduction is usually calculated taking into account acquisitions and dispositions of real estate assets during the relevant period so that EBITDA is not disproportionately reduced by adjustments for assets that were not held for the entire period.

As is the case in the net worth calculations described above, REITs' fixed charge coverage ratios are sometimes calculated to reflect the REITs' most current, as opposed to historical, performance. For example, a REIT's EBITDA can be calculated as four times EBITDA in the most recently ended fis-

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cal quarter rather than EBITDA for the four fiscal quarters most recently ended. Since this method of adjusting EBITDA for purposes of fixed charge coverage ratios has the effect of measuring current performance characteristics of a REIT, it would benefit REITs that had a relatively bad fiscal quarter or two for reasons that are not expected to recur, but, of course, this method could have the effect of magnifying the effect of a single bad fiscal quarter. As in the case of net worth tests calculated based on net operating income for one fiscal quarter, these calculations of EBITDA take a short term view of a REIT's performance until the REIT reaches a stable level of performance where historical EBITDA provides a more accurate prediction of the REIT's future performance.

Fixed charge coverage ratios for REITs having relatively large investments in individual real estate assets tend to provide for adjustments to EBITDA calculations based on changes in real estate holdings. For example, EBITDA realized on assets sold during the relevant fiscal period included in the calculation might be disregarded, while EBITDA realized during that period on assets acquired might be annualized (that is multiplied by a factor that treats the assets as held for the entirety of the relevant period). Such adjustments to the EBITDA calculation might be subject to manipulation by careful timing of dispositions and acquisitions, but overall, they would seem to make a fixed charge coverage ratio more closely reflect whether a REIT's assets produce sufficient earnings to cover its current fixed charges (assuming that the fixed charges are also similarly adjusted).

Fixed Charges

Items included in fixed charges tested in fixed charge coverage ratios imposed on REITs include:

- dividends on preferred equity;
- interest;
- capitalized interest;
- amortization of debt discount;
- scheduled amortization of debt (sometimes excluding balloon payments);
- a pro rata share of the fixed charges payable by non-consolidated entities in which the REITs invest; and
- ground lease payments.

In addition, in some cases, instead of deducting reserves from EBITDA for purposes of calculating the fixed charge coverage ratio (as discussed above), reserves are added to fixed charges. This approach has an effect similar to deduction of reserves from EBITDA by increasing the denominator instead of decreasing the numerator in the fixed charge coverage calculation.

Fixed charges are generally calculated over the same period as the EBITDA against which they are compared. If EBITDA is calculated for four fiscal quarters, then the fixed charges are calculated for those four fiscal quarters. If EBITDA is calculated based on one fiscal quarter, the fixed charges are similarly calculated. Similarly, if EBITDA is adjusted to reflect the acquisition and disposition of assets, fixed charges are similarly adjusted.

Leverage

A traditional leverage covenant compares a numerator composed of the borrower's indebtedness or funded indebtedness (which is generally defined as obligations for bor-

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rowed money and the deferred purchase price of assets and services) to the value of its assets. A leverage covenant is intended to test the adequacy of a borrower's assets to satisfy its debts. The issues about real estate values that have caused REIT net worth and leverage covenants to deviate from standard formulations as described above have likewise impacted leverage covenants.

Indebtedness

To the extent that indebtedness is deducted from assets in calculating net worth or tangible net worth in a REIT agreement, the same indebtedness is usually the numerator in the leverage covenant. (Funded indebtedness is rarely used in REIT leverage covenants.) When a REIT's net worth is calculated based on net operating income without deduction of indebtedness, the definition of indebtedness used in the numerator of the leverage covenant tends to be the same as the standard definition that would have been used in a more traditional net worth test.

Denominator of Leverage Covenant

The value of a REIT's assets used in the denominator of the leverage ratio is not always the traditional balance sheet value of assets determined in accordance with GAAP. Even when the minimum tangible net worth that a REIT is required to maintain is calculated based on balance sheet items, the denominator of the leverage ratio might be determined based on the type of net operating calculations used by other REITs to calculate tangible net worth. Similarly, a REIT might calculate its tangible net worth based on net operating income but use balance sheet values in calculating the leverage ratio. When net worth or tangible net worth is calculated in one way for a net worth covenant and in another way for a leverage covenant, financial covenants are looking for information about both historical values (balance sheet items) and performance characteristics (income items).

To the extent that adjustments are made to the definition of indebtedness used in a leverage covenant, the denominator is usually similarly adjusted. For example, if indebtedness of non-consolidated investments is added to indebtedness included in the numerator, a pro rata share of the assets held in (or, if the denominator is calculated based on operating income, a pro rata share of the operating income from) those investments typically would be added to the denominator. In those cases where cash is deducted in calculating indebtedness (and, therefore, decreases the numerator of the leverage covenant), the denominator would likewise be reduced by deducting cash.

Conclusion

In addition to the financial covenants discussed in this article, other financial covenants commonly being imposed on REITs include minimum operating income to interest expense ratios, minimum liquidity requirements, minimum occupancy requirements and debt service coverage ratios (the ratio of net operating income or EBITDA to principal and interest debt service). Virtually all of these covenants make adjustments to standard formulations reflecting the current economic climate but, in so doing, these covenants have created structures that require creative and on-going accounting, business, and legal attention to insure that they continue to achieve their intended purposes in light of changes in the business environment.

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NOTES:

[1]The Internal Revenue Code (the "Code") defines a real estate investment trust as an entity (a) that is managed by trustees or directors, (b) the beneficial ownership of which is evidenced by transferrable shares or certificates, (c) which would be taxable as a domestic corporation absent special treatment under the Code, (d) that is neither a financial institution or insurance company, (e) the beneficial ownership of which is held by 100 or more persons, (f) subject to certain limitations is not closely held, and (g) meets a number of special requirements relating to sources of its income, the value of its real estate and other assets, and minimum distributions. 26 Code Section 856.

[2]Credit, loan, and other financing agreements reviewed for purposes of this article are available through the United States Securities and Exchange Commission's Electronic Data Gathering, Analysis, and Retrieval system ("EDGAR").

[3]Other common financial covenants include the current ratio (the ratio of current assets to current liabilities), quick ratio (ratio of cash, cash equivalents, trade receivables, short-term investments to current liabilities), minimum profitability, and interest coverage ratio.

[4]See generally, Wright, Richard, The LSTA's Complete Credit Agreement Guide (2009) at 293 et seq.

[5]At least 95% of a REIT's gross income (excluding gross income from prohibited transactions) must come from dividends, interest, rents from real property, gain from the disposition of certain stock, securities and real property, foreclosure property, loans secured by mortgages, and mineral royalties. Code Section 856(c).

[6]Code Section 857(a).

[7]Some stock dividends can satisfy the REIT dividend requirement. See generally Code Section 305(a).

[8]Code Sections 856(c)(4)(A) and (5)(B).

[9]See generally, http://www.ifrs.com/updates/aicpa/Backgrounder_pdf.html.

[10]See generally, http://www.fasb.org/jsp/FASB/FASBContent_C/ProjectUpdatePage&cid=1176156576143.

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