OAK INVESTMENT MANAGEMENT GROUP

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Covenants and Real Estate

Covenants are the bond between the occupier's contract and the likelihood that they will actually pay the amount specified in that same contract. Covenants are the life blood of commercial real estate – as distinguishing between good and bad covenants is as important as assessing the physical condition of the building itself.

There are plenty of pitfalls as there are many 'glamorous' sounding covenants and there are plenty of opportunities in 'unglamorous' sounding covenants. On the one hand, there are covenants that have a great deal of exposure – even ubiquity – for example on the high street but which can trade on razor thin margins and could quick disintegrate in an tough economic environment. On the other hand, there are covenants which are incredibly obscure but which soldier on in good times and bad.

For listed companies, of course, it is easy to get a view of the rest of the market as to their strength either through assessing the underlying performance of their stock or through default *premia*. But for the majority of commercial real estate occupiers this shorthand for the strength of the covenant is not available. It requires a deeper investigation into the revenue generated by the real estate in question, the proportion that that has to the rent (known as the sweat ratio) as well as the overall health and applicability of the business strategy of the company in question to the economic environment.

This requires qualitative judgement as well as an understanding of the role played of the real estate in the business process of the company in question. It is quite possible to have an incredibly successful business as occupier of real estate but for this not to translate into higher rents. The skill in real estate investment is to be able to ascertain the need of the occupier for the real estate, to service in a collaborative manner their continued occupation as well as to realise the full pricing power of the real estate.

Companies that work throughout multiple jurisdictions often use different vehicles or many use daughter / associated entities to shield their main balance sheet from liabilities associated with real estate. This is a grey area where the real estate investment manager in conjunction with legal team needs to be sure that the right reward for the right risk. It is important that the correct covenant is in place, that its nature and scope is clearly understood, it is legally enforceable and properly valid. A vicarious guarantee can be as good as direct access to a corporate's balance sheet – but this needs to be closely examined and scrutinised for flaws.

Since the quality of covenants is not immediately and easily apparent, associated real estate is often not properly priced. This presents a considerable investment opportunity for the focused and disciplined investment manager. With the appropriate pricing and a clear strategy assessing the covenant will provide a good source of *alpha* when investing in real estate. Like so much in real estate the information is readily available – it just requires the diligence to make sense of it.

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