

Tenant covenant strength and why it matters

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Accordingly investors need to educate themselves about numerous factors including the specific industry sector that tenant is in, and what factors drive their particular business.

For example, is a tenant's business recession proof? Is it overly seasonal? Is it exposed to a significant threat of competition or cannibalisation? Can they adjust overheads in a market down turn? Is it exposed to overseas supply chain issues? or shifts in consumer sentiment or buyer behaviours? or government regulation?

And even more simply, is their product or service expected to be in demand 10 or 20 years from now in order to have greater confidence that the rent will be paid during the period of the tenant's lease.

While a corporate parent company guarantee or a (partial) rental security deposit held in cash or via a bank guarantee can go somewhat toward mitigating re-letting risk for a landlord, such instruments are unfortunately not without their weaknesses depending on where such parent guarantee ranks in the pecking order (among often many other similar guarantees issued by the company), while a bank guarantee usually doesn't cover the likely lease up time (void) a landlord might incur when seeking to replace a tenant, not to mention the leasing costs a landlord incurs in doing so.

When evaluating tenant covenant strength, at Unity, we look beyond a tenant's headline credit rating and importantly look at not just the above factors, but also the specifics of the lease agreement which can either compliment or in some cases, undermine what would ordinarily be perceived to be a "stable investment grade" tenant.

Furthermore, while assessing a publicly listed tenant (which is subject to periodic analyst coverage) is a more transparent task, it is not the case for those unlisted/privately held companies which are frequently private equity backed and more often than not, subject to high leverage.

In closing, the word to the wise is that brand recognition doesn't always equal covenant strength, and the covenant strength in especially a single-tenanted commercial property, is not simply an assessment of the ability of that tenant to pay rent today, but also in the future.

Source: Unity Capital Partners.

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