Research Update:

Federal Realty Investment Trust Rating Lowered To 'BBB+' On Prolonged Elevated Leverage; Outlook Stable

March 10, 2022

Rating Action Overview

- We expect Federal Realty's leverage metrics to improve over the next 12 to 24 months but remain above our tolerance for the prior rating, with S&P Global Ratings-adjusted debt to EBITDA around 6x.
- We lowered our issuer credit and issue-level ratings on Federal Realty to 'BBB+' from 'A-' and our rating on the company's preferred stock to BBB- from BBB.
- The stable outlook reflects our view that the company will exhibit solid operating performance and will fund acquisitions and development in a largely leverage neutral fashion.
- At the same time, we assigned our 'BBB+' issuer rating to Federal Realty OP LP, which we view as a core subsidiary of Federal Realty Investment Trust. The outlook is stable.

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Rating Action Rationale

Federal Realty's S&P Global Ratings-adjusted debt to EBITDA to remain at or above 6x through 2023. As of year-end 2021 Federal Realty's S&P Global Ratings-adjusted debt to EBITDA was 7.1x, down from 7.4x at year-end 2020, but still significantly above the mid-5x area where the company has operated historically. We expect credit metrics will continue to improve organically over the next several quarters upon accretion of EBITDA from redevelopments, acquisitions, and stronger operating performance. As a result, we estimate debt to EBITDA will improve to the low-to-mid-6x area by 2022 and around-6x area by 2023. We believe these leverage bands are commensurate with REITs rated 'BBB+' rather than 'A-' rating, where adjusted debt to EBITDA is typically in the mid-5x area or below. Moreover, we believe that headwinds inherent to retail properties could exacerbate operating disruptions and cash flow volatility as demonstrated over the past couple of years, and require additional cushion relative to other REIT property types.

In addition, we believe that opportunistic acquisitions could further deviate credit metrics from sustained deleveraging, depending on the funding strategy it pursues. As of year-end 2021, Federal Realty had $264 million available from forward equity sales, which we expect it will settle during 2022 to fund acquisitions or development. However, under our base case we do not anticipate a material reduction to debt levels over the next 12 months. (We adjust debt to include preferred stock, operating and financial lease liabilities, pro rata debt from unconsolidated entities, and is net by cash in hand. In addition, EBITDA is based on rolling 12-month financials.)

Federal Realty's high-quality portfolio should exhibit sound operating performance. We consider that Federal Realty's portfolio of high-quality, open-air shopping centers located in first-ring suburban locations means it will benefit from strong demand over the next couple of years. In our view, Federal Realty's retail portfolio with higher-than-peer-average in-place rent per square foot of $29.69 (compared with $20/sq. ft. for the peer group) demonstrates the high quality of the properties, which we expect will remain key for attracting tenants. During the last quarter of 2021, Federal Realty grew lease occupancy to 93.6%, up from 91.8% from first-quarter 2021, and showed healthy rent spreads at a blended 7%. We anticipate additional lease gains over the next few years trending back to the mid-95% area based on strong forward leasing volumes and a relatively healthy retail environment overall. We expect solid same-property operating income in the low- to mid-single-digits over the next couple of years.

The company's mixed-use expansion pipeline will boost EBITDA. We expect substantial growth in cash EBITDA from development and redevelopment projects upon rent commencement, largely in the second half of 2022 and in 2023. As of year-end 2021, Federal Realty had a $1.4 billion redevelopment pipeline, which we consider somewhat high relative to the company's gross asset base at book value (about 14% of gross assets at book value). About 70% of the cost has been incurred, with about $450 million remaining through 2024 (about 4.5% of gross assets at book value). Its largest projects including its mixed-use Cocowalk, Assembly Row, and Pike & Rose (for a combined cost of about $890 million) developments are largely complete and highly leased, which we think greatly mitigates execution and lease-up risks. We expect these projects to drive about $65 million of incremental operating income through 2024 upon rent commencement and burn-off of free rent periods.

Outlook

The stable outlook reflects our view that the company will exhibit solid operating performance and fund acquisitions and development in a largely leverage neutral fashion. The stable outlook incorporates our expectation for credit metrics to improve organically from a broader EBITDA base but also assumes debt will remain around current levels over the next 12-24 months. We expect S&P Global Ratings-adjusted debt to EBITDA in the low-6x area through 2023.

Downside scenario

Although unlikely over the next couple of years, we could lower the rating on Federal Realty if:

- The company adopts a more aggressive funding growth strategy with debt to EBITDA increasing to and remaining above 7.5x; or
- The company experiences operational disruptions that contract net operating income or affect occupancy levels.

Upside scenario

Over the next couple of years, we could raise our rating on Federal Realty if:

- Adjusted debt to EBITDA improves to and remains below 5.5x; or
- The company's asset base grows materially, with sound operating performance and above-average occupancy rates and in-place average base rent.

Company Description

North Bethesda, Md.-based Federal Realty owns, operates, and develops retail and mixed-use properties in densely populated and affluent communities in metropolitan markets in the Northeast and Mid-Atlantic regions of the U.S., as well as in California and South Florida. As of Dec. 31, 2021, Federal Realty's portfolio encompassed 104 predominantly retail real estate properties comprising approximately 25 million sq. ft. with $9.4 billion in gross assets. As of year-end 2021 comparable property operating income increased 11.4%, the portfolio was 93.6% leased, and rent increased 7% on a cash basis.

Our Base-Case Scenario

The recent rapid spread of the omicron variant highlights the inherent uncertainties of the pandemic but also the importance and benefits of vaccines. While the risk of new, more severe variants displacing omicron and evading existing immunity cannot be ruled out, our current base case assumes that existing vaccines can continue to provide significant protection against severe illness. Furthermore, many governments, businesses and households around the world are tailoring policies to limit the adverse economic impact of recurring COVID-19 waves. Consequently, we do not expect a repeat of the sharp global economic contraction of second-quarter 2020. Meanwhile, we continue to assess how well individual issuers adapt to new waves in their geography or industry.

- U.S. real GDP growth of 3.2% in 2022 and 2.3% in 2023;
- U.S. unemployment rate of 4.0% in 2022, declining to 3.7% in 2022;
- Same-property revenue growth of 4% in 2022 (mid-point of the company's guidance) and 3% in 2023;
- Gross margins of approximately 67%;
- General and administrative expenses of $50 million in 2022 and $54 million in 2023;
- Acquisitions funded with asset sales and equity issuances;
- Development spend of $350 million in 2022 and $300 million in 2023;
- Maintenance capital expenditure (capex), including tenant improvements/leasing commissions of $125 million in 2022 and $100 million in 2023; and
- Dividend payments of about $350 million in 2022 and $360 million in 2023;

Liquidity

We assess Federal Realty's liquidity as adequate. We think liquidity is enhanced by full availability under its revolving credit facility, available proceeds from forward equity agreements, and the absence of debt maturities over the next 12 months. We believe the company has sufficient liquidity to fund its development and dividend distributions.

Our assessment of the company's liquidity profile incorporates the following expectations and assumptions:

- Liquidity sources will exceed uses by at least 1.2x or more over the next 12 months;
- Liquidity sources less uses will be positive, even if forecast EBITDA declines 10% (a REIT-specific threshold for adequate liquidity);
- Sufficient covenant headroom for forecast EBITDA to decline 10% without the company breaching coverage tests, and debt at least 10% below covenant limits;
- The likely ability to absorb high-impact, low probability events with limited need for refinancing;
- Sound relationships with banks; and
- A generally satisfactory standing in credit markets.

Principal liquidity sources

- Cash in hand of $162 million as of year-end 2021;
- Full availability under its $1 billion revolving credit facility due in 2024;
- We estimate funds from operations of $500 million-$550 million annually over the next 24 months; and
- Available proceeds from forward equity agreements of $264 million at year end 2021.

Principal liquidity uses:

- Development spend of about $250 million over the next 12 months;
- Dividend distributions at about $350 million;
- Capex and other leasing costs of $100 million-$130 million; and
- No debt maturing in 2022 and $275 million notes maturing in June 2023.

Environmental, Social, And Governance

ESG credit indicators: E-2, S-2, G-2

ESG factors have had no material influence on our credit rating analysis of Federal Realty. Although the company's environmental initiatives do not currently drive materially higher operating margins, we view the company's progress on energy efficiency goals favorably. In particular, we see Federal Realty's investment in LEED-certified buildings as supportive of our Strong assessment of its business risk profile. At year-end 2021, the company had invested a total of $2.3 billion to receive a LEED certification, most notably its projects under construction including Assembly Row and Pike & Rose. Moreover, we note that 65% of Federal Realty's properties utilize LED lightning technology, which we think could potentially yield expense savings over time. We believe this could modestly enhance the attractiveness of the properties to potential tenants with a higher focus on environmentally efficient locations.

Ratings Score Snapshot

Issuer credit rating: BBB+/Stable/--

Business risk: Strong

- Country risk: Very low
- Industry risk: Low
- Competitive position: Strong

Financial risk: Intermediate

- Cash flow/leverage: Intermediate

Anchor: bbb+

Modifiers

- Diversification/portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- Criteria | Corporates | Industrials: Key Credit Factors For The Real Estate Industry, Feb. 26, 2018
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013

- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

New Rating		
Federal Realty OP LP		
Issuer Credit Rating	BBB+/Stable/--	
Downgraded; Outlook Action		
	To	**From**
Federal Realty Investment Trust		
Issuer Credit Rating	BBB+/Stable/--	A-/Negative/--
Issue-Level Ratings Lowered		
Federal Realty Investment Trust		
Senior Unsecured	BBB+	A-
Preference Stock	BBB-	BBB