

UNSECURED DEBT AND REIT CAPITAL STRUCTURE*

Timothy J. Riddiough
Massachusetts Institute of Technology
Center for Real Estate, W31-310
Cambridge, MA 021394307
(617)253-51311tjidd@mit.edu

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EXECUTIVE SUMMARY

REAL ESTATE RESEARCH INSTITUTE

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Many REITs have recently touted the advantages of debt financing-in particular, the use of unsecured debt as an alternative to secured debt and equity financing. The primary argument for unsecured debt as a substitute for secured debt is that it increases operating flexibility due to the ability to "reshuffle the asset deck" at any time. An important implication of this argument is that use of unsecured debt is value increasing since it lowers the firm's weighted average cost of capital.

This study questions the received wisdom by pointing out that unsecured debt is also flexibility reducing in several respects. Relative to use of secured debt, it decreases the firm's option value to defaulting on individual assets and bond covenants impose firm-wide restrictions on future operating and financing policy. If these flexibility costs are important to investors we might actually observe an increase in the firm's weighted average cost of capital when unsecured debt is first issued.

In this study I empirically examine the unsecured debt - cost of capital question. An event study methodology is employed to measure stock price reactions to unsecured debt issuances. I find that stock prices react *negatively* to initial offerings, but react *positively* to follow-on offerings. I argue that focusing on the initial offering is more important, since the flexibility related aspects to issuing unsecured debt are first introduced at this stage and are essentially sunk effects when follow-on debt is issued. The evidence at the initial offering stage supports the flexibility reduction argument that I propose and contradicts the more standard flexibility increasing argument. I also examine the determinants of stock price reaction and find that high growth firms and non-UPREITs have large and significant price declines when unsecured debt is initially offered. These findings also support the flexibility reducing view proposed in this study.

In general terms, this research shows that how a firm is financed (the right-hand side of the balance sheet) can affect overall firm value (the left-hand side of the balance sheet). This is because financing decisions can impact after-tax cash flows of investors, they can provide information about the current value of existing assets and management quality, and they can provide insight into the expected future operating decisions of the firm. In other words, an analysis of strategic shifts in a firm's capital structure can provide clues as to the firm's current and future investment performance.