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Fitch: Higher US Military Housing Maintenance Costs Pressure Ratings

Fitch Ratings-New York-24 June 2021: Continued elevated expenses due to moisture remediation could lead to further negative ratings pressure for US military housing bonds with exposure to environmental issues, Fitch Ratings says. Some military housing operators have been accused of neglecting routine maintenance, allowing unsafe housing conditions to develop. Over the past year, Outlooks for 11 of 13 rated military housing transactions have been revised to Negative from Stable due to liquidity erosion and increased expenses.

In 2020 and 2021, Fitch downgraded and placed on Negative Outlook four transactions with Negative Outlooks because of large increases in operating expenses that negatively affected debt service coverage ratios (DSCR). Fiscal 2019 operating expenses increased substantially from 2018, in many cases by double digits, as a result of maintenance and repairs tied to environmental remediation. DSCRs continue to decline from historically high levels in 2018.

The operator's ability to maintain housing quality, sustain strong occupancy levels and control project operating expenses is important to project cash flow stability. Military housing transactions also benefit from cash reserves, usually sized at maximum annual debt service, to guard against cash flow volatility. Some transactions have reinvestment funds to offset some of the increased expenses that are only to be spent with the approval of the appropriate service branch. Reinvestment funds are quickly being depleted, and should they be exhausted, the DSCR could plummet.

Military housing operators have been hit with a number of lawsuits in Texas and Washington alleging unsafe housing conditions. Operator revenue is often based in part on meeting performance objectives set forth in contracts with the applicable service branch. Two former employees of Balfour Beatty pleaded guilty to fraud for covering up military housing issues between 2013 and 2016 at Lackland, Travis, Vandenberg, Tinker and Fairchild Air Force Bases (AFBs). Maintenance documents were falsified to allow the company qualify for incentive payments received upon meeting certain maintenance targets. Capmark Military Housing Trust XXXIX AMC West (which covers Travis, Tinker and Fairchild AFBs) was downgraded last July to 'A+'/Outlook Negative from 'AA'/Outlook Stable.

Military bases saw a rise in insurance premium expenses. Some incident claims are coded as uninsured losses until it is determined whether the claim will be covered. Once bases receive reimbursement, Fitch may attribute insurance payments to cash flows when invested back into the project.

Higher expenses and marginal basic allowance for housing (BAH) increases can result in some deals having less than break-even coverage, per Fitch's Military Housing Criteria break-even thresholds for investment-grade ratings. Most military housing project revenue is derived from the BAH, which is informed in part by the rental rates in the community. Given the reliance on federal appropriations, BAH may be impacted in the longer-term by the uncertainty of future federal programmatic spending on housing programs. The median BAH rate for all military service members across all installations increased 3% from 2020 to 2021, similar to the 2.7% increase from 2019 to 2020. For Fitch-rated military housing projects, median rates increased 1.1% from 2020 to 2021.

Sustained declines in occupancy could also pressure ratings. Project vacancy rates have increased, primarily driven by increased remediation and the Department of Defence’s freeze of Permanent Change of Station during the pandemic. This resulted in a subsequent decline in rental revenues for the duration of the freeze, which was lifted in June 2020.

Military housing projects with a Negative Outlook or Watch have been assigned elevated environmental, social and governance (ESG) relevance scores of ‘5’, reflecting the concerns regarding exposure to environmental site risk and associated remediation costs.

Contact:

Mikiyon Alexander
Senior Director, US Public Finance
+1 646 582-4796
Fitch Ratings
Hearst Tower
200 W. 57th Street
New York, NY 10016

Sarah Repucci
Senior Director, Fitch Wire
+1 212 908-0726

Media Relations: Sandro Scenga, New York, Tel: +1 212 908 0278, Email: sandro.scenga@thefitchgroup.com

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