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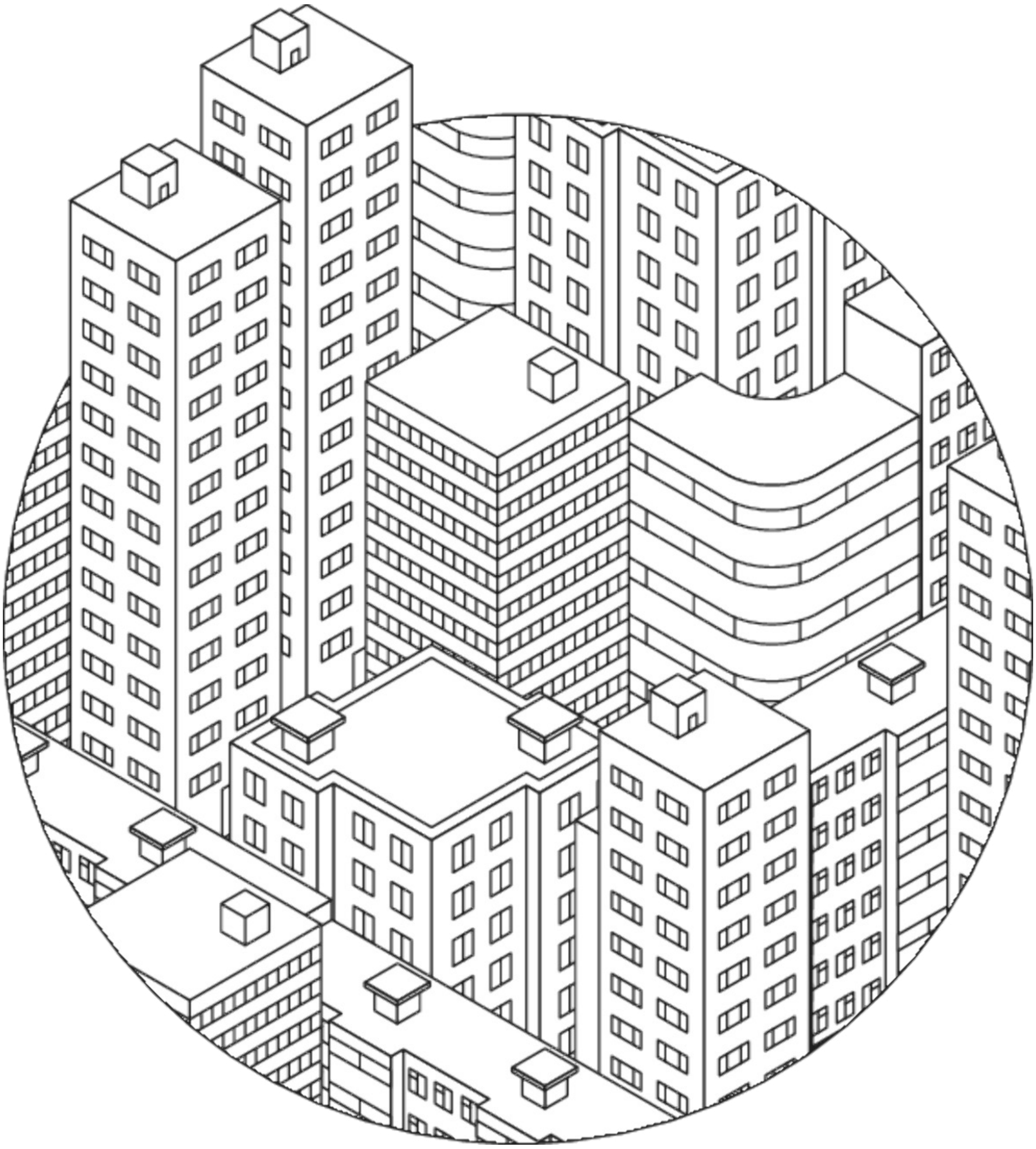

Commercial Real Estate Sector

A Landlord and Tenant Playbook

MAKING AN IMPACT THAT MATTERS since 1845

Introduction

The commercial real estate (CRE) market is currently in a state of flux, with mixed messages circulating regarding the severity and longevity of the implications from Covid19. In essence, at this point it is difficult to determine exactly when this crisis will ease or when any degree of "normality" will resume in the market.

Whilst the CRE market remains a comparatively attractive and long-term secure investment, strategic decisions will need to be made by key stakeholders in order to recover and thrive from this crisis.

The Deloitte Real Estate Advisory team have prepared a brief playbook to support both landlords and tenants across the CRE sector on actions they will need to take across a variety of current challenges.

Key impacts of Covid19 on the primary CRE sectors:

Retail

There has no doubt been a shift in the retail industry as a whole and landlords may need to consider alternative uses on certain property types outside of the main high streets. Tenants are currently experiencing high exposure to staff, inventory and bricks-and-mortar costs and significant restructuring of their cost base will be required. Many retailers have been effectively non-operational for a significant time, and are withholding rental payments in order to survive. A phased or protracted return to normal footfall levels will also prolong problems.

Office

The office sector is less likely to experience large scale impacts. Operating either at full capacity, or in many cases at a reduced remote working presence, it will experience primarily economic impacts. Commercial office and industrial occupiers continue business activity but are incurring operational costs, with exposure to reduced income generation. Technology is crucial to occupier survival, and the ability to work from home will have lasting impacts on the internal operation of the office space, but will likely strengthen the office as a place to work; a social, collaborative and interactive destination for employees.

Industrial

Supply chain management has been disrupted. Logistics and supplies will remain in demand albeit with reduced tertiary activity due to economic deflation.

Landlord and Tenant Playbook

In order to recover and thrive from the Covid19 crisis, appropriate preparation and proactive engagement is required from both landlords and tenants. Below we look at a number of step-by-step scenarios and actions required by landlords and tenants on some of the main impacts stemming from the Covid19 crisis:

Landlord

Impact	Action
Concessions	• Concessions such as rent holidays and rent abatements may need to be offered to tenants. • Lease renegotiation is likely to occur. The long term impacts on tenure and valuation should be considered carefully, and comprehensively.
Tenant failure / restructuring process	• Many tenants, particularly in the retail sector, will enter a restructuring process. Scenario plan the exposure to this by undertaking a full due diligence on the current and likely financial performance of occupiers. • Identify liabilities in order to pre-empt tenant failure.
Cash flow disruption by reduced rental income, unpaid service charges and other costs	• Scenario testing is required, through cash flow analysis of the existing lease obligations. • Engage with existing occupiers. • Consider alternative payment structures, temporarily reducing rental payments, to be recouped at later stages in the contracted lease term if possible.
Mitigate valuation impact	• Imminent lease event dates to be considered as re-gear opportunities, to mitigate valuation impact. • Valuation assurance: Challenge rent and yield on existing valuations through sensitivity analyses. • Undertake options analysis and modelling on alternative use / repurposing scenarios. • Restructure financing model with funders/financing institutions. • Incorporating flexibility on existing leases has long-term impacts on cash flow and value. It is vital this is incorporated appropriately in order to mitigate this monetary impact. • Engage with occupiers to ensure sustainable tenancies going forward, to reduce the likelihood of vacancies. .
Active asset management in operation of asset	• Collaboration and engagement required between Landlord and Tenant, and Funders where applicable. • Scenario analysis of upcoming lease events. • Prepare and implement risk sharing opportunities in order to drive footfall and reduce costs for retailers. • Managing the occupancy levels yet maintaining footfall as restrictions are eased can provide certainty and trading comfort in retail environments.
Planning constraints	• The repurposing of many shopping and retail centres to mitigate value losses will need careful due diligence. Lease covenants to anchor/owned unit tenants will have to be carefully reviewed, appropriate market & commercial due diligence undertaken and appropriate planning advice taken on board. • Appropriate planning and legal advice on alternative uses for repurposing existing space.

Tenant

Impact	Action
Costs exposure	• Retailers will mitigate costs to manage short term cash flow shortage through reducing labour costs or rental overheads. • Office occupiers are likely to reconsider their occupational requirements and space utilisation.
Reduced cash flow	• Office occupiers to assess their existing office space and occupational obligations, in line with their occupational requirements. • Retailers to review commercial financials including turnover, costs and projections and identify what mitigating actions can be taken to preserve cash in the short/medium term. • Retailers to analyse staff, inventory and bricks-and-mortar costs.
Cost Reduction: concession, consolidation and sublease scenarios	• Review lease and complete scenario analysis of upcoming lease events. • Engage landlord on potential for rent concessions, lease restructuring or other opportunities. • Cost savings for office occupiers through consolidation and active asset management of the underutilised office space; subletting of space, releasing of office space to the market, or the restructuring of existing leases.
Cash flow and business operation	• Reforecast trading and projected cash flows for the short and medium terms, and engage with the landlord accordingly. • Alternative payment structures may need to be considered so that both parties can continue operationally and financially. • Retailers will need to engage landlords and have clear defined payment structures and agreements in place during periods of limited cash flow and footfall restrictions. • Both parties will need to see a prospect for survival in order to agree a corrected rent. • In the event financial difficulties remain for tenants or agreement cannot be reached with landlords, there are several restructuring options available to avoid a terminal insolvency scenario including Examinership, Part 9 Scheme of Arrangement or Managed Exit.

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