

COVID-19: a 360 degree overview of the current challenges and opportunities in the real estate sector

June 2020



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COVID-19: challenges and opportunities through the lens of the real estate sector

As businesses and governments around the world continue to adapt to, and embrace the ‘new normal’, we invited a group of our key clients within our Real Estate Group in London to join us for a virtual roundtable discussion on the current real estate-specific issues, themes, trends and critical areas they have encountered in the current market and what the future looks like in the real estate sector in the post-COVID-19 world.

This was the second virtual roundtable that we hosted for clients of the Reed Smith Real Estate Group in the UK. With the UK now several months into lockdown, it was interesting to hear the issues, challenges and dilemmas currently facing the real estate sector. We enjoyed another fascinating and lively discussion with our clients.

Our in-person and virtual roundtable events are part of a series we have developed and designed to create a platform for senior business leaders, general counsel, legal and business teams and senior management representatives to share relevant experiences, discuss live issues and explore ideas for the future of legal service delivery. Through our established roundtable programme, we aim to foster a real peer-to-peer learning environment for our clients to ensure they are able to discuss real and current issues in an informal but informative setting.

Our roundtable events, in their virtual and in-person formats, are held under Chatham House rules. Therefore, as always with our follow-up thought leadership reports, we have not provided specific names or examples and have kept this report confined to themes. This report outlines the key themes that emerged from our discussion, and some of the ‘now and the next’ areas, which seemed to be highlighted during the conversation with our clients.

As we continue to explore some of the critical issues within the real estate sector, we are grateful to our clients for sharing their honest thoughts and feedback on the current challenges they are facing, and we will ensure to continue the dialogue with them as we move into the post-COVID-19 era.

The current economic climate is uncertain, volatile and unpredictable and the insights shared by business leaders into the current and emerging issues enable us to provide flexible, pragmatic and commercial support to our clients.



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Scan this code to download and view our first report from our ‘Real Estate: the now and the next’ thought leadership series in 2020.

Please note: Throughout this report quotes in “*red italics*” are direct quotes from the session

COVID-19 as an accelerator of change

The COVID-19 crisis has brought some unforeseen challenges for many businesses and economies and while the future is still unclear, the message from the real estate market is clear: the pandemic has only accelerated some of the changes and challenges that we have anticipated for a long time.

- The pandemic has been described by clients as “*a catalyst*” as it has managed to “*accelerate many of the changes that were already happening*”.
- Clients believe that many of the challenges that we have seen in the real estate sector are just a direct response to already existing trends. For example, in the retail sector, the increased move from physical shopping to e-commerce or online shopping has been anticipated and evidenced for several years, and it has now been largely accelerated due to the pandemic.
- Clients also indicated that the increased need for flexibility in the workplace has been highlighted during the pandemic. This crisis has provided an opportunity and “*we have proved that we can be trusted to work [remotely] and independently from our colleagues and teams*”.

The now and the next

- Technology can no longer be referred to as ‘pure IT’. The need for many businesses to have an entire tech infrastructure to support and maintain their operations has paid dividends as it has helped many companies to adapt quickly and efficiently to the new remote working environment.
- Technology is now seen as essential infrastructure for businesses and it is the modern version of getting on the train. “*However it is not the end of an era*” in terms of the end of the office environment.

Clients discussed how it is “*amazing how well we’ve done [as a society]*” given the difficult circumstances businesses have had to endure, and that “*if this was 10 years ago, it would have been a disaster*”.



The economic reality

COVID-19 has been described as a crisis with an unprecedented nature and scope, which has brought some serious challenges for businesses to scope out and predict what the future in the post-COVID-19 world will look like. From the perspective of global economies, there seems to be a common fear that the worst is yet to come.

- The biggest concern for many clients is that, politically, *“the cure is worse than the disease”*, meaning that the UK government’s response to the crisis might have a more negative impact on the real estate sector than the pandemic itself in the long-term.
- In real terms, when faced with a crisis, for many businesses, *“the traditional standard playbook goes out of the window”*. Because the scale and nature of this crisis is unprecedented, many businesses were not prepared and are now in danger of insolvency.
- Within the real estate sector, landlords are mindful of the ‘snowball effect’ that a large number of insolvent tenants might have on their portfolio and the economy overall. For example, a landlord with a portfolio primarily made up of small and medium businesses (SME) tenants speculated that if one-third of their tenants became insolvent as a result of the pandemic, this could have a snowball effect across the sector in terms of the value of rents across their entire portfolio, their ability to collect rent, and their ability to meet their credit obligations to their banks, etc.
- Clients admit that some industries which have been *“hit the hardest”* are likely to be *“last to recover”*. Specifically, hospitality and leisure are two sectors where recovery is expected to be slow and difficult.
- The hospitality and the leisure sectors had been on a journey of positive transformation before the pandemic. With the rise of social media platforms like Instagram, hotels had become an attractive

***“The
cure is
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destination for non-guests and experience-seekers. Since the pandemic, this trend *“has now spun 180 degrees”* in reverse and industry professionals are of the view that it might be some time before this trend goes back to the pre-COVID-19 days.

- Clients are of the view that the crisis is still *“in its starting phase, not its end phase”* and that *“there is a very wide range of possible scenarios [that are yet to emerge] and we don’t know in what direction things will change”*.

The now and the next

- The law of economics has established that this is not the first crisis that we have faced and *“the nature of crises overall is that they do happen”* and businesses should, therefore, always be prepared to face all potential crisis situations.
- During the heat of the COVID-19 crisis, clients expected to see a move *“from a tenant-based market to an investment-based market”*.
- The equity markets, by contrast have shown positive signs regarding the state of the real estate sector. Because of the timely intervention from the government and the central bank through the investment of funds, which helped to provide some measure of protection to some businesses, clients commented that they have not seen the *“shakeout”* that they expected.
- Uncertainty and unpredictability will continue to be the forecast for businesses, going forward. Clients are still concerned about how things will play out in the future.



The commercial versus legal reality

For many landlords and tenants, the pandemic has created some serious difficulties for their businesses, and while they try to find practical ways to get their business back to 'normal', the legal 'redlines' are increasingly overlooked in favour of a more commercial approach to resolution, also known as "the commercial reality".

- From the perspective of legal redress, the real estate sector *"likes the 'redlines' that have been created within our sophisticated landlord and tenant system"*. However, the new commercial reality for many tenants and landlords has forced them to navigate the crisis towards *"a spirit of increased collaboration"*. Clients commented that *"it feels naïve to think that the legal redlines mean as much as they did"*.
- Clients note that in the context of an economic crisis and a corresponding difficult business environment, *"the legal playbook goes out of the window"*.
- When the COVID-19 crisis began and developed back in March 2020, many landlords and tenants spent a lot of time with their external counsel to review their leases and to identify legal options available to them and where the redlines in their contracts were. As the pandemic has progressed, the approach has changed and the outlook is much more long haul and the spirit of collaboration has kicked in, *"to ensure the survival of both tenants and landlords"*, meaning that the commercial reality is increasingly favoured over any potential legal action.

The now and the next

- Legal redress and remedies and what is available to landlords and tenants, are generally important to know and understand, and the legal *"rulebook is useful"* to understand. However, to foster a mutually-beneficial relationship between landlords and tenants and to ensure survival of both parties through practical and commercial solutions, collaboration between both parties is key.
- The current situation has been described as *"an uncharted territory"* and therefore, the legal rulebook *"just doesn't have the gravitas that it once did [before the pandemic]"*.
- The commercial reality of the pandemic has brought landlords and tenants closer together with a mutual desire to forge a long-term partnership – an unexpected consequence of the pandemic – as a way to respond to the crisis together and help each other in the recovery period.

"It feels naïve to think that the legal redlines mean as much as they did"

The human angle of the crisis:

Are we seeing a positive movement in the traditional relationship between landlords and tenants?

While many businesses and governments are still dealing with the aftermath of the pandemic, with its significant commercial and economic consequences, within the real estate sector, there has been an increased emphasis on the relationship between landlords and tenants. The COVID-19 crisis has helped both landlords and tenants to understand the importance of working together to future-proof the survival of the sector.

- Clients admit that it feels like most of their tenants have been very much on the front line during the pandemic and that it *“has hit them the hardest”*, and that before anything else, *“this is a human tragedy”*.
- While the rental collections in the first quarter of the year were, in most cases, above the expected levels, clients shared that *“the human aspect of the March/April collection was right in your face”*.
- Among some groups of tenants, *“there is a complete sense of distress out there”*. This applies specifically to the groups of tenants with SMEs, who generally have difficulties providing a real forecast on what their businesses will look like in three years' time.
- Some landlords with large portfolios of SME tenants have developed a grading system to help identify those tenants who are considered to be at a real risk of becoming insolvent. These are tenants who have seriously struggled to meet their rental obligations. The grading system is designed to help them work together to find a commercial and mutually beneficial solution, for example, moving the tenants to monthly or even weekly based rental payments, agreeing temporary deferments and occasionally agreeing to rent holidays, perhaps in return for extended terms and/or changes to break dates, etc.

The now and the next

- Most institutional landlords realise the need to focus on relationship building with their tenants and to get to know and understand their businesses.
- Whilst landlords have faced mounting pressure from their investors and banks, they are increasingly looking to work with their tenants to find workable solutions that are beneficial to all parties.
- While landlords are generally seen as *“credit-based investors”*, they admit that their *“tenants are paying the rents”* and that they have been focused on creating a rapport with their tenants.
- Looking ahead, it is difficult to estimate what rental collections will look like in the June 2020 quarter, but clients believe that there has never been a better time to *“get to know the tenant, and to get to know their business”* in order to create a collaborative environment for negotiations and meaningful dialogue. *“It has to be a side by side relationship”*.

“Get to know the tenant and get to know their business... it has to be a side by side relationship.”



Real estate – the future outlook beyond COVID-19

Clients admit that they anticipate a wide range of possible scenarios beyond 2020 for the real estate sector. While some existing trends of declining demand and transformation within the real estate sector have been further highlighted and strengthened during the pandemic, clients are also positive about potential new opportunities within certain asset classes.

- Overall, clients continue to see urbanisation as a strong theme, although some admit that the pressure for development of residential buildings will help increase investments in development and construction outside of London.
- Retail is expected to continue to decline and clients do not see this trend changing.
- Looking forward, “[*the demand for*] office space is questionable” but clients are certain that “[*the demand for*] offices is not dead at all”, albeit it will live in a different shape and form. Some expect to see an increased move towards flexi, shared type offices. Tenants will demand flexibility and will want to proactively manage their space, and there will be an increasing trend for smaller and more bespoke offices.
- Within the SME sector, it is expected that more people will move to homeworking and that, by contrast, the larger (corporate) tenants will want to go back to the office culture. Productivity was acceptable in the first few months of lockdown; however, since then, productivity has gone down and this has led to the desire for some tenants to return to the office.
- Clients with different portfolios (away from office space) see the future in different types of investments. They are considering investing in properties that would be “so critical to the tenants’ businesses that they could not live without it”, such as R&D, warehouse and distribution facilities.
- Across the board, clients believe that they will need to be far more involved in the operational side of the management of their properties, despite all of the risks that this might present.

The now and the next

- Clients admit that for some asset classes, the fact that this crisis has gone on for months, not weeks, “has actually done the real estate sector a favour”.
- Clients are of the view that, had the crisis ended quickly, remote working would have been favoured and become the ‘new office’ and would have led to the end of the office culture. However, in reality, the long-term nature of remote working has impacted the separation between the professional and personal lives of office workers, thereby causing a shift in thinking and the need to return to the office.
- Looking forward, landlords plan to “get far more involved in the operation side, rather than look at more institutional core landlord management” and create a “side-by-side relationship with the tenants” in order to be able to respond to increased public safety and social distancing requirements.



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