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Real Estate

Five Commercial Real Estate Trends to Watch in the Wake of COVID-19



November 2021

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It's been a whirlwind 20 months for commercial real estate (CRE), which, like so many other areas, was hit particularly hard by COVID-19. According to a [recent report](#), the pandemic created the worst recession the office sector has ever faced — leaving property owners to seek out new ways to entice tenants, navigate changing lease structures, and manage any number of other COVID-related issues. Moreover, COVID-19 has caused many observers to challenge and question the fundamental way we work and, more importantly, where we work.

On the flip side, despite the pandemic's persistence, other areas in CRE have proven remarkably resilient. As the economy continues to recover, PwC data shows that an enormous amount of investment is ["surging into real estate."](#)

No matter the case, the ups and downs of CRE will continue on into 2022, presenting new challenges, opportunities and uncertainties. With that in mind, here are five CRE trends to watch, along with important pieces of guidance to help owners prepare in this evolving market.

1) The rise of new lease structures: short-term, flexible and others

Considering the shift to remote or hybrid working, the decline in some CRE values, and the ongoing uncertainty brought on by COVID-19's resilience, it's no surprise that many tenants want flexible and short-term lease structures. This is especially true for smaller deals and current leases, many of which have seen short-term extensions.

With that said, new leases haven't been as impacted as many may think: [more than](#) 75 percent of new leases signed in the first half of 2021 were for terms greater than four years, and 25 percent were for terms of 10+ years — percentages consistent with pre-pandemic levels. The full impact of COVID-driven changes in working and space use may not be realized until larger, existing leases come up for renewal or until there is clarity around the extent to which remote working will effect a permanent change in office space usage and, ultimately, demand.

As far as other pandemic-related lease terms go, the last 20 months have made evident that force majeure definitions must be amended to account for circumstances like COVID-19. Otherwise, however, not much has significantly changed when it comes to these lease terms. Tenants generally have been unsuccessful in shifting force majeure risks to landlords, although in a few instances tenants (mostly retail tenants) have been able to negotiate protections if they are unable to conduct their business in the future due to pandemic-like events.

Key Takeaways:

- Lenders, developers, contractors, landlords, tenants and borrowers need to assess the impact of relevant provisions or clauses related to "Force Majeure" or "Unavoidable Delays" on construction contracts, leases and loan documents that may extend times for covenant performance. This is especially important now, as rampant supply chain shortages continue to cause construction delays.

2) Pressures mount to design a new type of office

By now, we're all aware of the ongoing (and unresolved) discussions around the future of office spaces and new models of working. While certain companies have decided to mandate a return to the office, many more have accepted the fact that flexibility will be an important recruiting and retention issue well after COVID-19 passes. Many of these companies are actively exploring ways to make coming to the office attractive to their employees, either through the physical attributes of the space, enhanced amenities, or proactive programming to ensure that time in the office is well spent and dedicated to matters that can only be accomplished by in-person interaction.

Landlords will need to work with tenants to adapt to these conditions. For those with vacant office space, solutions for driving up demand might involve enhanced amenities, more outdoor spaces (e.g., terraces, courtyards), and less densification. Some of these amenities (like gyms) might be provided by the landlords themselves, while others (like retail spaces) may be addressed through promoting third-party leases with users that will complement and serve this need. At the same time, landlords will have to adopt new safety protocols, such as better air filtration and extra cleaning, that will heighten cost pressures.

While many suggest the rise of co-working and flexible office spaces may serve some of this demand for flexibility — JLL [predicts](#) percent of office space to be flexible in some form by 2030 — it remains to be seen whether this market will actually pick up steam as many anticipate.

Key Takeaways:

- Building amenities aren't enough — landlords need to work with existing and prospective tenants to reimagine the office, uncover the purpose it serves in this moment (e.g., a site for collaboration and interaction), and figure out how to make it a space employees want it to be. One challenge for landlords is that tenant feedback has historically indicated that tenants and their employees don't actually use many of the amenities they've built. Landlords will need to be creative and forward thinking in this endeavor.
- Landlords looking to build new amenities might need to explore alternative arrangements with tenants to help keep their businesses afloat amid pandemic shortfalls (while also creating an exit strategy should obligations not be fulfilled). Such arrangements might include short-term leases, percentage rent accommodations (i.e., the tenant pays a specified portion of sales revenue in lieu of a fixed monthly rent), and management agreements (i.e., where the landlord takes over as owner of the business).
- Some landlords may seek to fill vacancies through licensing vacant space as fully furnished, flexible office space until they can get a long-term tenant. A few landlords have teamed up with experienced management companies or flexible space operators in order to do so. By pursuing such pre-built, flexible office spaces, landlords [can](#) deploy less capital into real estate and give employees more choice over how and where to work.
- In the months to come, there will be uncertainties around what happens when leases are renewed and what changes there may be to financing underwriting (e.g., requirements of operating reserves, leasing expense reserves, guarantees to mitigate short-term shutdowns, partial lease renewals, termination, or contract rights). Landlords should be prepared to handle those potential changes as renewals approach.

3) Climate risk and carbon emission laws will continue to impact leasing, especially during COVID-19

The construction and operation of buildings now account for nearly 40 percent of global [carbon dioxide emissions](#) — so it follows that numerous cities and states have adopted carbon emission laws for CRE owners and developers. In New York City, for instance, Local Law 97 sets carbon-emission targets for every building with more than 25,000 square feet and no rent-regulated units; fines for not meeting these targets can run in the millions of dollars. Thus far, the legislature has rejected all requests by the real estate industry to slow the implementation of these laws or provide other relief in light of COVID-19.

These concerns had been mounting before COVID-19 underscored the importance of improved (carbon-emitting) ventilation systems and limited landlords' profitability. Retrofitting buildings across New York City could [cost](#) over \$4 billion, and tenants are increasingly sensitive about the pass-through costs of additional operating expenses.

Meanwhile, ever-growing climate risks pose their own threats to CRE, with an [estimated](#) 35 percent of real estate assets worldwide exposed to climate hazards like flooding and hurricanes.

Key Takeaways

- Pass-through costs — whether they involve carbon-related fines or improved ventilation systems — will become crucial aspects of lease negotiations. For instance, certain tenants might argue that each tenant should not share in these types of costs equally (e.g., if fines are triggered due to excessive carbon emissions, these may be due to a particular energy-intensive use — such as a trading operation — and other tenants are likely to question whether fines levied on the building should be passed through to all tenants). Fines are also a cost that landlords often do not have the right to pass through to tenants as an exclusion to operating expenses. Landlords and owners need to have informed and experienced counsel when dealing with these negotiations — particularly in a time when demand for space is likely to be reduced.
- Landlords and owners should also stay abreast of any legislative changes in the geographies in which they operate. For example, there have been [efforts](#) in New York City to amend Local Law 97 and make it easier to meet emissions requirements. Though initially unsuccessful, this and other efforts can have a critical impact on the CRE industry moving forward.

4) Vaccination requirements pose new challenges for property managers

There continues to be extensive focus on the impact of vaccine mandates. For instance, if a tenant notifies their property manager that they are requiring employees be vaccinated to enter the office, how might that impact the outside contractor hired to clean the premises or conduct necessary repairs and maintenance? Does the property manager have the contractual right to make sure those employees are vaccinated? How might unions and collective bargaining rights factor into those decisions?

Key Takeaways

- Landlords need to be proactive in both contacting vendors about vaccine mandates and communicating to tenants. Tenants do not have the right to force outside contractors hired by the building to be vaccinated. They

can waive rights to services but do not typically have the right to exclude contractors hired by the landlord to conduct inspections or necessary repairs. Owners should also be communicating to tenants if someone in the building has tested positive for COVID-19, as well as what precautions and cleanings have been undertaken in light of that news. Any process adopted by a landlord must be implemented consistently. Landlords should also be cognizant that future leases and service contracts may include provisions that allow a party to impose vaccine mandates.

- Remember, too, to be conscious of potential HIPAA violations when disclosing information about cleanings and cases — in these instances, be sure to not give out any names or information that might reveal someone's identity.

5) Areas in CRE to watch

Despite ongoing pandemic-related challenges, opportunities do exist in CRE. For instance, demand for logistics, industrial, data centers, life sciences and multifamily developments has been extremely strong during COVID-19. The question will be whether any of these areas are getting overheated and overvalued — and, consequently, whether that might drive capital into other sectors (perhaps even back to offices, as investors may view office pricing as depressed enough to present an opportunity). For now, though, market fundamentals and discipline have, broadly speaking, [held](#) up amid the pandemic.

The past 20 months have been a transformative time for the CRE industry and we're not out of the woods yet. Staying ahead of trends, making necessary preparations for the future, and mitigating legal risk will be crucial in the uncertain months to come.

We're here to help, and look forward to hearing any questions, comments and concerns you may have.



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