SAVILLS INSIGHTS

The Pandemic Changed Everything in Real Estate– Timelines for Office Space Negotiations Chief Among Them

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It does not take a Ph.D. to understand that world economics have been transformed by a devastating pandemic and other recent major geo-political events. Further, less obvious impacts of these events are drastically changing how office space tenants and commercial space users think, strategize and prepare for their current lease expiration dates and how they will use space going forward. This is especially true when there is the desire to potentially relocate and construct office space at a new location to encourage employees to return to the office.

It is hard to imagine how a pandemic and total disruption of the supply chain across industries and availability of raw and manufactured materials have anything to do with a lease expiration date, but it has everything to do with it. The reality is that most office space tenants are not allowing nearly enough time for the processes of real estate site selection, design, construction, and decommissioning (removal of personal property) of their current space to be able to move into the new office space prior to their current lease expiration date. When it is time to decide whether to sign a lease to stay, renew in place, or build and relocate, most tenants in the current market environment are left scrambling.

> **“Supply chain issues, labor shortages, construction delays, and events of force majeure are adding unimaginable amounts of time to project schedules and leaving real estate users in precarious positions.”**

Thus, this is forcing tenants to make difficult decisions to enter into short-term renewals or a costly holdover period (if either is an option). In some instances, tenants will be required to secure temporary co-working space or mandate their employees to work from home full-time as they watch their lease expire with no physical address to conduct business while the new office is only partially constructed. This situation is less than ideal for the companies who are employing drastic measures to bring the workforce back to the office and often, is perceived by leadership and employees as a regression.

Unfortunately, this terrifying scenario is becoming a more “normal” sequencing of events in the post-pandemic real estate process. This is fully avoidable if real estate brokers and tenants are able and willing to allow for significantly more time for their real estate process, especially since the onset of the pandemic.

A simpler time in the search for space

Prior to late 2019, building a site selection and project design/construction schedule for leasing and constructing new office space was relatively straightforward, particularly for the standard office space user. Except for minor considerations and special types of construction, real estate brokers and project managers were able to build schedules and timelines that would lead their clients down a path to success with simple rules of thumb and a largely predictable cadence. This process would allow for ample time to complete a thorough entry into the market, select a new site, conduct orderly negotiations, produce designs, complete construction, and relocate prior to the tenant's lease expiration.

Timeline Pre-COVID

- 2-4 Months: Entry into the market, site selection, and negotiations
- 2-4 Months: Lease negotiation activities and space planning
- 2-3 Months: Architectural design and engineering process
- 2-3 Months: City and fire department plan review (permitting process)
- 3-4 Months: Hard construction, relocation
- 1-2 Months: Decommissioning and removal of personal property in previous location

With pre-pandemic real estate project schedules following this general cadence, it was safe to assume 12 to 20 months (20 months for larger spaces) was ample time for tenants to embark on their search for new space. It would allow for a thorough and strategic exploration of all real estate options with enough time to complete the lengthiest portion of the process, which is usually construction of shell space and relocating to a new space. This timeline would only be subject to minor fluctuations based on the tenants' ability to make decisions and keep the process moving forward with approvals. The largest schedule risk in the pre-pandemic environment was usually city and fire department plan review which varies by jurisdiction, but at most this could cause a fluctuation of an additional four to eight weeks in the schedule. This delay was usually absorbed by schedule contingency if the real estate process was started early enough.

This concept is important because it allows tenants to keep all real estate options, including lease renewal, "in play" and allows them to maximize their leverage and negotiating power in the market. Even if the preliminary desire is to renew an existing lease, all tenants should follow this strategy to achieve the best leverage in negotiating with their current landlord.

As the world began shutting down in Q1 of 2020, there were many tenants who were deep into the real estate process, and some who previously signed or were ready to sign leases for new office space. Many tenants who were considering building new office space and signing new lease documents decided to pivot and sign short-term one to two-year renewals of their current space. This allowed tenants to quickly transition into a cash preservation mode as the uncertainty of the impacts of a national and global emergency quickly unfolded. Real estate construction projects, which were deemed "essential" as defined by the Centers for Disease Control and Prevention, continued to remain active.

Prices surge and supply chains suffer

By April 2020 with most states reporting widespread cases of Covid-19, active construction projects saw the first early indicators of force majeure with labor-related schedule delays. With the virus quickly sweeping through entire construction crews, tenant improvement job sites began shutting down for up to 15 days when Covid was detected. Once the site reopened, accessing enough healthy tradesmen to continue making progress was the next challenge for contractors and this only compounded the delays. These delays were manageable, and by themselves were still easily addressed in the overall project schedule contingency.

> **"Throughout 2020 and into early 2021 as unemployment rates skyrocketed, labor continued to be the most foreseeable issue for all industries, and specifically in the construction business as it relates to tenant improvement projects."**

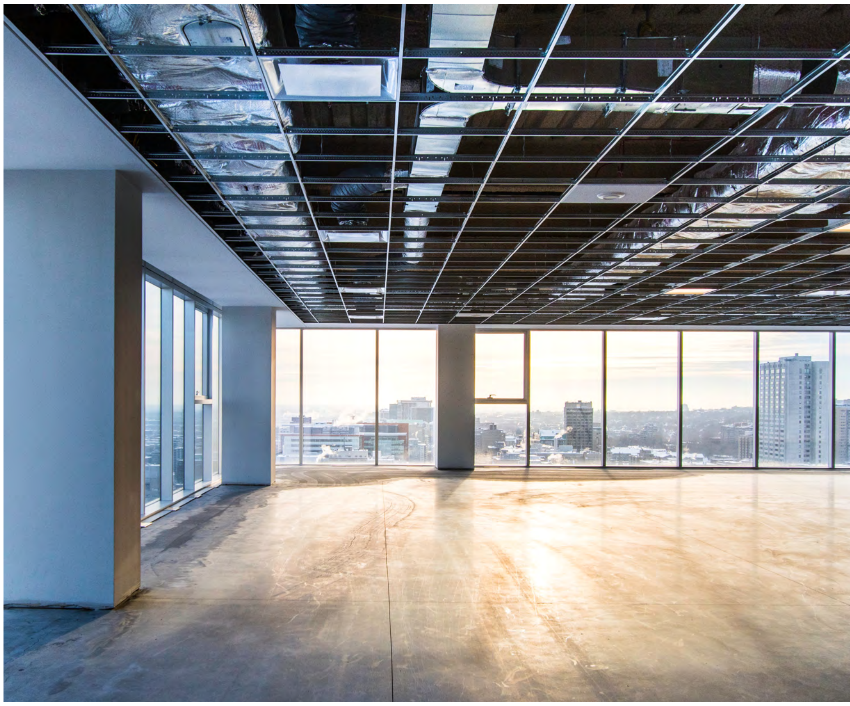
In spring 2021, the ugliness of supply chain issues emerged. One of the first indicators of the strain in the supply chain came in mid-2020 as the U.S. housing market surged. Home buying and renovations during the pandemic caused lumber prices to skyrocket from approximately $400 per thousand board feet in February 2020 to an all-time high of over $1,600 in early May.[i] As the lumber producers were shutting down like many of the manufacturing industries, the supply quickly fell short of the massive demand. This was rapidly felt on all active commercial tenant improvement projects causing shortages of doors, wood veneer, and other wood finishes. Lead times on doors, frames, and certain veneers rapidly surged to over 25 to 30 weeks, in some cases forcing contractors and tenants to settle for alternate materials that were in stock but not necessarily harmonious with their design.

The in stock products were quickly depleted. A blockage of the Suez Canal in March 2021 is an arguable tipping point that may have quickly exacerbated the world economy's ability to keep up with the demand for raw materials. Combined with factory shutdowns, labor shortages, and global inability to transport food, supplies, raw materials, and finished goods, the blockage was holding up approximately $9.6 billion dollars of goods per day[ii] and caused backups of maritime shipping for months. Labor shortages at the ports and in the freight industry meant that even after months of waiting, the boats carrying products could not be unloaded, or transported cross-country and ultimately were not arriving to the job site.

To add to the web of complexities, a natural decline in the availability of semiconductor metals occurred simultaneously with a pandemic-fueled demand for consumer technology and vehicles.[iii] Subsequently, lead times for tenant improvement construction materials (finished goods) such as lighting, control panels, fire horn, and strobe devices ranged from "unavailable" status to upwards of thirty-week lead times. Anything that required a microchip could be subject to massive delays which led to significant construction setbacks on active construction projects ultimately interfering with projected occupancy dates far past the general contractor's contractual obligations. With manufacturers, distributors, and, representatives unsure of when they could get products onto job sites, definitive lead times given to contractors were replaced with vague estimates that lacked commitment for when materials would ship. Construction schedules were pushed to double the original projections and to make matters worse general contractors were not able to project an end date with the uncertainty being presented by their suppliers.

These massive delays and doubts regarding materials persisted throughout the remainder of 2021. As construction schedules continued to slip, tenants' lease expiration dates were rapidly approaching with no signs of their new space being completed.

> **"When the world began regaining control of the pandemic and the process of "return to work" slowly began, employers with active construction projects were forced to continue the work-from-home model."**



As 2022 approached, the supply chain and labor shortage issues continued to persist, and supply chain issues became a moving target. Doors, glass, and lighting continued to require longer lead items, however, the suppliers were able to gather enough data to more accurately project lead times. Lead times for critical materials continue to be lengthy with no foreseeable relief. We watched in real-time as active projects that began procurement and buy-out process in Q1/Q2 of 2021 and were originally proposed as 18 or 19-week construction schedules were consistently completed around the 28 or 29-week mark. The schedule impacts are mostly if not solely, caused by the inability to get construction materials and finishes in a timely manner.

Take all the time you need and then some

What has our sector learned from 2021 considering the tangled web of supply chain, labor shortage, and continued infection of Covid variants? We learned that tenants cannot control how long it will take materials to get to the job site. We recognize that we cannot produce more labor in a market that is already stretched thin for the foreseeable future. We have come to accept that this dynamic could be the new "normal" and we must change and adapt our strategy. We know that what tenants can control is how much time they are willing to allow for the real estate and construction process to protect and indemnify themselves against supply chain issues as timelines sprint past their current lease expiration date.

When it comes to real estate project scheduling, the new normal requires a determination of how much time is needed to safely preserve your current lease expiration while providing for insurance that your new office can be constructed and operational prior to that expiration. It is similar to gathering firewood when you are in a wilderness survival situation. Initially, you gather what you think will be enough wood for one night. Once you have what you think will be enough, gather two times more wood than you originally gathered. Tenants need to apply this same rule of thumb when considering their real estate process in this post-pandemic "Upside Down" environment.

For starters, try to determine how much time you think you need for the entire real estate process from site selection through decommissioning, and then triple that amount of time. Tenants may think that when their broker calls them three years prior to their current lease expiration to jumpstart the process that they have plenty of time. However, three years prior to lease expiration is about the right time to initiate the process for larger space users in particular. Below is a viable schedule based on current market conditions to compare to the pre-pandemic schedule referenced above.

Timeline – Current (2022)

- 2-4 months: Confirming your unique in-office or hybrid model to determine space needs
- 2-4 Months: Entry into the market, site selection and negotiations
- 2-4 Months: Lease negotiation activities and space planning
- 2-3 Months: Architectural design and engineering process
- 4-5 Months: City and fire department plan review (permitting process)
- 8-10 Months: Hard construction, relocation
- 2-3 Months: Decommissioning and removal of personal property (multi-floor users) at previous location

As you can see, the real estate negotiation and design processes are very similar to the pre-pandemic schedule. However, as organizations struggle through defining their unique approach to space use and work-from-home/hybrid policies, two to four months of additional time will be needed to confirm the approach appropriate for each individual organization. Additionally, we are seeing longer trends in city and fire department plan review, longer construction schedules because of lingering supply chain issues, and delays in decommissioning and removal of personal property from existing space due to continued labor shortages, which does not show any signs of easing. To safely avoid the schedule delays and force majeure pitfalls, tenants should consider starting their real estate process at least 20 to 30 months prior to the current lease expiration to protect all options and maximize leverage in the market. There is certainly no harm in starting sooner.

Additional suggestions for tenants who are facing a lease expiration include the following:

1. Working closely with the tenant's architect and design team to research materials availability before specifying the materials.
2. Entertain an early pricing exercise with the general contractor community to onboard a contractor prior to the issuance of fully engineered construction drawings. This is an excellent way to engage another collaborator during the design process while vetting materials availability.
3. Tenants and owners should not rely on controlling construction schedules by simply requiring liquidated damages, consequential damages, or actual damages for tenant improvement projects. Although most contractors might be willing to agree to reasonable damages, they will not likely include damages resulting from supply chain issues, force majeure, shipping delays, or other major reasons causing projects to be delayed.

> **“In summary, timelines have been greatly extended for all phases of the real estate process.”**

Office space users that will return to the office in some manner must pay attention to the clock. In an environment where real estate timelines are continuing to stretch out longer, your ability to mitigate this risk diminishes greatly. To keep your leverage and the viability of delivering an environment to your employees on time, get started much sooner and move the process up on your priority list because 30 months go by quickly.

Sources:
i. How the lumber industry misread Covid and ended up with a global shortage and sky-high prices". NBC News. 28 June 2021. Link
ii. "Suez blockage is holding up $9.6bn of goods a day". BBC News. 26 March 2021. Archived from the original on 26 March 2021. Retrieved 31 March 2021. Link
iii. "Wait Times for Chips Grow Again in March as Shortages Drag On". Bloomberg US Edition. 5 April 2022. Link

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