

Tenant Protection in a World of Uncertainty

June 2023

There continues to be a growing focus in the media on the looming debt crisis for commercial office landlords across the nation. The crisis is a result of the continued surge in vacancy rates due to remote and hybrid work and an overall flight to quality amongst occupiers to provide the most highly amenitized spaces for their employees. This strategic shift in occupancy coupled with materially higher interest rates and the need for increased concession packages being offered to entice occupiers, has placed building owners in a perfect storm as the values of their buildings have declined significantly. The combination of the precipitous drop in income received, higher interest rates and consequential decreased valuation, limit an owners' ability to refinance its debt obligation while also placing the banks in a position where they may elect not to recapture the troubled asset due to the negative stigma it carries which in turn may affect its ability to lease the asset in the future. In many instances, banks are more inclined to work with their existing borrowers/ landlords rather than manage the asset themselves or face a potentially bigger write-off by selling the asset.

The media focus to date has largely been on both the potential impact to lenders as well as the already cash strapped cities that may be negatively impacted financially due to a decrease in their tax revenue base. What has been less publicized is the impact that these issues have on leasehold occupiers and how they can protect themselves for the foreseeable future.

LANDLORD/LENDER RESTRUCTURING PROCESS

Based upon the poor office fundamentals discussed above, several office landlords are upside down where their existing debt exceeds the amount they can refinance based upon the declining value of their building. Landlords that are underwater with their debt becoming due are faced with either handing the keys back to the lender or trying to refinance with their current lender. This restructuring process is very complicated and the outcome for tenants is almost impossible to predict. Lenders will typically complete a highest and best use analysis to determine if the building will have a higher valuation as a conversion to residential and/

or sell to an investor which could result in the lender foreclosing on the property and possibly selling the asset. Under this scenario, a tenant that has not taken the proper precautions and unfortunately signed a lease with a landlord that is undergoing this restructuring process could end up with substantial delays and possibly faced with a termination of its lease. If this tenant has an existing lease with an upcoming lease expiration its best-case scenario will be to obtain a short-term lease extension under reasonable terms with its current landlord, or be faced with holdover rents (typically 150 -200 % of its current rents) or be forced to go completely

remote work based while the process is resolved. Centre Square in Philadelphia is an example where this restructuring process ended up with the lender taking over the building and appointing a receiver to oversee the leasing and management of the building. Therefore, it's imperative that a prospective tenant and its broker take the necessary steps below to ensure that the landlord they commit to can perform. In fact, several regional office REITS such as Kilroy, Brandywine Realty Trust, Piedmont and Highwoods have mentioned on their first quarter 2023 earnings call that they have seen an uptick in tenants interested in their properties not only due to their high quality, but also because they are perceived to provide financial stability.

COMPANY AND FINANCIAL REVIEW

Historically, landlords were often quite skeptical of tenants and insisted on understanding their business models and completing thorough reviews of their financial statements to determine a security deposit that offset the perceived risk of tenant default while also ensuring that the landlord's out-of-pocket costs for such items as tenant improvement allowances and brokerage commissions were covered. In today's environment, tenants should be completing the same rigorous review process on their landlords to confirm that they are capable of both funding concessions and maintaining the building for the duration of the lease term. While some landlords are publicly traded REITs with readily available financial statements or traceable debt, others are harder to analyze and require further scrutiny. Tenants and their advisors should be demanding that landlords present on both their financial and managerial capabilities which should include a review of their financial statements, understanding of all assets within their portfolio and outlining a management and capital plan for their asset over the next 5-10 years. This uncustomary landlord review process will create an uncomfortable situation, but we expect it to become more commonplace over next year.

NEGOTIATION PROCESS

In many markets across the country, landlords are being incredibly aggressive with their concession packages to induce a tenant to make a long-term commitment to their building. In the negotiation process, tenants need to maximize their leverage however there have been more instances recently where a landlord has backed away from the concessions that were offered due to either a decreased valuation of the asset or the lack of lender approval. It is imperative that tenants understand a landlord's internal approval process for a transaction and be sure to keep multiple suitors in the race in case a landlord reneges on its promises.

LANDLORD FUNDING PROTECTION

It is not uncommon for a tenant's construction costs to exceed the value of the improvement allowance being offered by the landlord. Tenants may elect to pay for the full cost of the improvements and then be reimbursed by the landlord in a one-time payment at completion of construction or take draw payments from landlords over the duration of the construction period. In either scenario, tenants need to ensure that landlords can make the funds available when requested. Tenants must thoroughly document their available remedies in the lease in case of slow or non-payment from the landlord. A landlord security deposit is the best way to protect a tenant in a landlord default situation and can come in many forms including:

- Letter of Credit from the landlord's banking institution
- Cash deposit or escrow account
- Payment bond
- Parent company or personal guaranty

In addition to securitizing the value of the cash allowance, tenants should also consider

extensions of the free rent period, damages for delays in payment including interest and rights of termination, however this can be impractical following occupancy. Any work to be performed by the landlord should be completed prior to space delivery to the tenant to guarantee completion in advance of the tenant expending significant capital dollars.

OPERATING EXPENSES & TAXES

While payment of the landlord allowance is often the focus, tenants also need to be certain that their landlords will maintain the building and provide the services agreed upon for the duration of the lease term. This should include both cost containment and management of the building operating expenses. From an operating expense perspective, tenants should have caps in place for percentage increases and annual estimated payments should not be increased or modified until the tenant has received its annual reconciliation, with supporting documentation, and has ample time to review. In addition, tenants must maintain flexible audit rights that help prevent a landlord from passing through expenses that should be their responsibility. In cases where a tenant overpaid its annual operating expenses, the tenant should continue to protect itself via rent offset provisions and interest penalties until they have been reimbursed.

LANDLORD SERVICES

When it comes to landlord services, tenants will need to have a clearly defined scope of services in their lease document with self-help rights, landlord default language and a termination clause in scenarios of non-performance. Landlord services and amenities are often a key reason why a tenant selects a building, so it is imperative that these services are as detailed as possible and include an array of items including but not limited to, building access, security, janitorial services, HVAC performance, and operation of building amenities (i.e. café, fitness facility and conference facility).



Jay Joyce
Senior Vice President,
Branch Manager
+1 267 256 7565
jjoyce@savills.us



Matt Sall
Senior Managing Director
+1 267 256 7570
msall@savills.us



Elaine Marquardt
Managing Director
+1 267 256 7579
emarquardt@savills.us



Daniela Stundel
Research Manager
+1 267 256 7576
dstundel@savills.us

