X TEAM RETAIL LEASING STRATEGIES

IN POST-COVID

Eviction moratoriums and other government regulations disrupted many facets of the economy and real estate industry in 2020. The impact of those decisions is continuing to be felt in 2021 as retailers and landlords across the country grapple with ways to re-open stores and bring occupancies back up at shopping malls.

Landlords and retail brokers must find new ways to work together today with the backdrop of the eviction moratoriums that may be causing them to re-negotiate existing leases at malls and other retail properties. X Team brokers Lunden McGill of Baker Katz in Houston, Brian Gast of Velocity in Phoenix, and Evan Albert of mfi Realty in Baltimore share their insights from the front lines. The advice and insights these retail experts at X Team Retail Advisors offer provide a landlord's perspective to help educate tenants on what to expect and what strategies are best aligned to demand, and challenges faced in 2021.

Landlords that were proactive with tenants when they saw the writing on the wall when Covid arrived, tended to fare better, notes Velocity's Gast. "All landlords during Covid handled deals differently with tenants especially restaurants, fitness or entertainment retailers, which were categories hit the hardest," said Gast. "Those that got in front of issues, now are the most successful, while others that didn't are behind the eight ball."

In Texas, Baker Katz's McGill notes that "in the earlier days and in the middle of Covid, most landlords played ball in a sense, because they were interested in helping tenants and it was a mutually beneficial situation." The majority of tenants in McGill's market that fell out involved tenants that were already struggling to survive even before Covid hit. "No one that went out of business in our market was a surprise. If anything, Covid was an apt excuse not to be in business anymore," she added.

Market activity is robust in the Washington, DC Metro at a time when retail activity typically dies down, notes mfi Realty's Albert. "It is the busiest I've ever been in six years, but the leasing business has shifted from landlord representation to more tenant representation now, which is creating competition for sites," said Albert. "This is the first time that I've seen three to four tenants fighting over the same space, especially top-quality real estate or sites that have drive-thru's." That is forcing tenants to chase deals to get their preferred space and landlords are more frequently asking for higher rents for those premium spaces.

Conversely, other less appealing spaces can sit vacant. While that was a challenge for lower quality space even before Covid hit, those landlords know they must remain flexible since they understand the space may sit awhile because there's less tenant demand for them now. "There are two spectrums," said Albert. "All or nothing. It is a very unique time. And landlords now are picker abouts the tenants they complete deals with."

McGill adds that activity today is being fueled by pent-up demand and backlogs caused by not doing deals during Covid. She points out that franchise concepts "owe stores" whether in a pandemic or not. "Retailers may have been required to deliver two stores in a market as part of their growth strategy that Wall Street is tracking, but they couldn't during Covid so now they are aggressively pushing forward on deals, which are hitting the market simultaneously," said McGill.

Some major national retailers' expansions or contraction strategies are being influenced by whether a state or market is opened from Covid-related shutdowns or has tough restrictions in place now. Baker Katz's McGill notes, "Those factors are creeping into the metrics and decision-making process. We are seeing more retailers lean towards lenient states such as Texas, and that's a unique position to be in now."

Gast points out a downside to Covid was how it impacted plans. "Some developer and landlord deals that were in progress when Covid hit, went smoothly and went forward, while others paused or faded away. Some deals that were in escrow got extended a couple of months with no penalty, or landlords offered two months of lease grace. That was different compared to the market in 2008, when deals "just died and went away," notes Gast. An example of how that is playing out today and the patience required is Gast just signed a deal that had died when Covid arrived in 2020. Transaction timing is being prolonged or pushed back as those who want to move forward figure out how to make deals work now because it is a different market today with rising construction costs. That may mean considering offering concessions or percentage rent. But Gast adds, "Generally, we have gotten back to the way it was before Covid now."

BOPIS TREND EXPANDS

Buying online and picking up in stores (BOPIS) is a trend that grew substantially over the past year including the emergence of drive-thru's. This is one of the key trends Baker Katz's McGill is tracking closely in Texas to see which retailers are adopting BOPIS strategies. "Now, Chipotle has really refined and dialed-in its online ordering process and pick-up in person. That is new income and a revenue stream that many hadn't paid as much attention to before. Covid has caused them to do so now," she said.

Retailers that seek to accommodate customers via the tech side of business today "will be leader of the pack," notes McGill, adding that it has required retailers and restaurants to "adapt quickly" to the detailed and intricate BOPIS systems.

Velocity's Gast says, "During Covid drive-thru sales on the whole were up 15-20%, which is driving the success of free standing QSR stores. By contrast, Covid accelerated the death of some retailers, even mediocre tenants got taken out of the game. The solid ones who knew what they were doing accelerated sales, and that has put them in the spotlight now. Those that didn't had to reinvent ways to make money if they couldn't offer dining."

Restaurants quickly learned if they couldn't offer pick-up or take-out they needed to embrace BOPIS and either add or expand their drive-thru capacity, says Gast, who notes that trend is driving a "hot pad market." Chipotle is working on introducing a drive thru concept called Chiplane and many others such as McDonalds, Burger King, Taco Bell or Filbert's are exploring ways to expand their drive-thru or drive-up business.

RECALIBRATING EXPECTATIONS

It is a new market for both tenants and landlords today that requires an approach aligned with market realities. Baker Katz's McGill says, "Landlords must take a holistic approach and both sides have to completely recalibrate expectations now. Retail brokers are working to educate landlords and tenants as to what a realistic environment is in today's market." The expectation for many was that retail was failing and wouldn't survive Covid shutdowns. Rent decreases were expected to follow the challenging period on 2020. The reality is different, points out McGill.

"Construction prices are soaring, and tenant demand is back on stronger than ever," she said. That means landlords are needing to go back to tenants preparing to build-out space and share why rents actually need to increase because of the rising construction costs. "Those who accept the new reality are ahead of the game, which is a blessing for the industry but makes for some hard conversations with retailers expecting to get a deal or have the red carpet rolled out for them by landlords."

The delta between expectations and reality is painful for retailers. McGill says, "Most clients expected take advantage of a market that is not there now, despite the pain and heartache experienced during the Covid downfall. We are in a different spot thankfully and that is driving activity, including retailers that are moving quickly to take advantage of new space availabilities from those who didn't survive the pandemic."

The landlords that proactively worked with tenants throughout the pandemic likely found solutions, too. Velocity's Gast cites a landlord in the Phoenix market that he works with as an example of a model to follow.

He completed three new restaurant deals at Desert Ridge, a high-end lifestyle center in Phoenix owned by SKB. The landlord recognized the challenges restaurants faced and offered two months of rent abatement upfront to existing restaurants rather than add it on at the back end of a lease. Other landlords may have added two months of term on the back end of deals.

Savvy landlords understood each retailer and restaurant faced tough times and would require lender support for a couple months. That helpful approach went a long way with tenants initially and as the pandemic shutdowns progressed, landlords recognized tenants required more help since they were faced with capacity issues. That meant incorporating delivery services such Uber Eats or expanding take-out options for some, though for fine dining establishments other considerations were necessary. Gast said, "Landlords that valued a tenant long-term adopted the approach that could include letting a tenant pay half rent or percentage rent in an effort to relieve stress and help tenants bridge to better times." In some cases, that resulted in longer commitments. "If a landlord could secure a new 7- to 10-year deal to replace one that had three years remaining, they would write off Covid concessions for a longer term," said Gast.

TERMS AND CONTINGENCY CONSIDERATIONS

mfi Realty's Albert notes that it has become increasingly important for a landlord to pick quality tenants when negotiating retail leases today, rather than the first tenant that shows up at the door. He advises landlords not to be "obnoxious with lease comments but to be in deal-making mode. A tenant could move to another space, or they could face an uncertain future as a result of the ongoing health pandemic.

It is key to be flexible today, points out Albert, since an attitude of 'it is my way or the highway' doesn't produce the best results. He says, "Tenants are considering multiple spaces at one time now, even for a single requirement, so if they lose out on their preferred location, they have back up options. That requires landlords to be more creative with deal structures, offer more TI allowances, or offer percentage rent to keep the base rent low."

Personal guarantees from retailers are giving way to letters of credit (LOC), which landlords now prefer because it helps protect them against a tenant bankruptcy and the funds can be drawn to cover rent. Tenants appreciate LOCs too because they can help protect their personal assets.

Albert notes he is seeing tenants seeking pandemic clauses in leases, though landlords mostly are reluctant to provide them. Typically, only retailers like Starbucks or Ross Dress for Less are able to get them. Landlords don't feel compelled to add such clauses anymore as they did at the pandemic's outset because they see the market has stabilized and they have pool of tenants from which to pick.

It is natural for tenants to want Covid language included in leases to help protect them should future government shutdowns occur. Some landlords have added in language that outlined what would happen and how they would work with tenants in the event of another shutdown. "More is needed to iron out issues and work through the impacts of eviction moratoriums, back-rent and concessions," said Gast. "But ultimately landlords still must pay their lender and other bills. Even when a tenant can't pay rent, the landlord still has a mortgage to consider. In the short-term they can carry tenants, but if a center is shut down tenants can't remain in place for free."

Baker Katz's McGill agrees it is fairly standard now in the industry to have a Covid contingency in leases if the government shuts down a tenant or a business. They are typically pre-negotiated rent relief, or cover force majeure provisions.

Another factor to consider are construction timelines for new space. Build-out periods are now extended in the Washington, DC Metro because permitting offices are behind by as much as five months. Albert also notes he's seeing rising construction costs in the market, as well as labor shortages, too. Some retailers are not able to meet opening date requirements due to the fact they can't staff a store and no applications are coming in. They may need add 90 days of extension or pay dark rent, notes mfi Realty's Albert, who adds that every landlord that he's worked with is doing a blend of extensions or securing CAM expenses and taxes for the last 90 days of build-out.

Looking back over the past year of Covid, Gast says a key takeaway is that strong collaborative relationships triumph over challenges. "Covid is an anomaly, and no one knew what to expect," says Velocity's Gast. "Neither the landlord nor tenant could prepare for unknowns that were revealed during the pandemic. It wasn't a landlord or tenant's market it was a two-way street. That is why both must work together to find solutions now. In most cases, shrewd landlords proactively communicated with their tenants and got in front of issues when they recognized a tenant was struggling to keep up with rent."

Today, landlords and retailers face an environment where multiple solutions must be considered. Keeping an open mind to find creative ways to get a lease executed may include rent abatement, concessions, or renegotiating deals with longer terms. It may also mean being flexible regarding fixturizing periods and opening dates that get pushed back due to no fault of the tenant when permits for construction build-outs are delayed due to backlogs or slower processes at planning departments. Retailers and landlords across the country can find ways to re-open stores and bring occupancies back up at shopping malls when they collaboratively work together with retail tenants.