CADWALADER

REF news and views

The Commercial Real Estate Landscape in the Post-COVID World

By **Jessica Wong**
Special Counsel | Real Estate

Although the long-term impact of the coronavirus pandemic is not yet clear, the social distancing requirements and health concerns, along with the shift towards remote working, reduced travel, and increased online shopping, will change the landscape of commercial real estate – in particular, offices, hotels and malls, which make up more than half of the mortgages in commercial mortgage-backed securities transactions.

The COVID-19 pandemic had an immediate and profound impact on the commercial real estate sector, and the commercial real estate landscape in the U.S. will likely be dramatically transformed as we emerge from the pandemic. When the pandemic started rapidly moving across the U.S. in March, the spread of the shelter-in-place and work-from-home orders throughout the country – together with the economic turmoil, healthcare challenges, and social distancing – negatively impacted all sectors of the commercial real estate market, although some more than the others. Hotel and retail properties were among the swiftest and hardest-hit categories by the pandemic, as owners were forced to immediately close their properties when cities and counties instituted shelter-in-place orders, while industrial properties and some office properties faced less of a decline. As local economies continue to open up across the country, owners of commercial properties will need to adapt their properties and operations to the post-COVID world.

For retail properties, the pandemic has exacerbated many of the issues that have challenged such properties prior to the pandemic. While some retailers that offer essential goods, such as grocery stores and home improvement stores, have flourished during the pandemic, these stores are typically not located in shopping malls which have been struggling in recent years. Online shopping, which has reduced the need for brick-and-mortar stores, has surged since the pandemic started and will likely continue to grow. In addition, anchor tenants, which had been the lifeblood of malls by attracting visitors, had been vacating large amounts of space prior to the pandemic, and numerous well-known chains, including Neiman Marcus, JCPenney, Lord & Taylor, Pier 1, J.Crew and Brooks Brothers have filed for bankruptcy since the pandemic started.

The pandemic has accelerated the efforts of retail properties to adapt their properties to secure their long-term viability. In recent years, owners of retail properties have been adapting their properties and redeveloping empty anchor space for alternative uses, including turning such space into entertainment complexes, fitness centers, houses of worship, residential properties, and restaurant and dining facilities. But as social distancing requirements will likely keep capacity and foot traffic at a reduced level, mall owners are modifying their business plans for a post-pandemic world. The Related Companies has indicated they plan to redevelop the space that will be left empty by Neiman Marcus at Hudson Yards into office space. Simon Property Group, the largest mall owner in the U.S., is currently under discussions with Amazon to convert empty retail space in malls, particularly those left empty by anchor tenants like Sears and JCPenney, into fulfillment warehouse centers. Simon also joined with Authentic Brands Group to supply financing to Brooks Brothers through its bankruptcy and a sale of Brooks Brothers to Sparc Group, a 50-50 joint venture between the companies for $325 million. This includes a commitment to keep 125 Brooks Brothers stores open, an arrangement that has been approved by the U.S. Bankrutpcy Court of the District of Delaware, with a closing date scheduled for as early as August 31. This isn’t the first time a mall owner has acquired a bankrupt retailer. Last year, Simon teamed up with Authentic Brands Group and Brookfield Property Partners to purchase the bankrupt Forever 21. The acquisition was reported as a way for Simon and Brookfield, which were Forever 21’s biggest landlords, to keep Forever 21 as an anchor in their properties to avoid triggering any co-tenancy clauses that could result in other tenants being entitled to a right to lower their rent or terminate their leases early.

Hospitality properties are likely to take the longest time to rebound, as travel for business and leisure has dramatically declined and is likely to stay that way for the foreseeable future as multiple states have had to reverse plans to reopen amid surging COVID-19 infections and the current absence of a vaccine. Some reports have indicated that demand for hotel lodging may not return to pre-COVID levels until the third quarter of 2022. While some hotels have chosen to remain closed even as these orders are lifted to save on operational expenses, other hotels have chosen to pivot from their customary operations. In certain jurisdictions, including New York City, hotels have adapted their properties to serve as quarantine housing for individuals who have contacted the virus or to house homeless people during the pandemic. Other owners of hotels are trying to devise new strategies for their properties, including the conversion into office space. The owners of the Bryant Park Hotel in New York City, which had been converted from office space into a hotel in 1998, announced their intent to convert the property back into office space.

The conversion of other properties to office space is likely a result of the outlook for office properties appearing less dire than other sectors. During the height of the pandemic, many office tenants continued to pay rent for their space, even though much of the space was left empty while employees worked remotely. This large-scale and immediate move towards remote work has led many companies to come to the realization that their office employees are productive and can work as effectively remotely, which may lead to a reduced demand for office space. However, the long-term impact on office properties will likely not be evident until tenant leases expire and tenants consider the amount of space needed going forward. In the short term, office owners will need to adapt their properties to consider health and safety concerns of office employees arising from the virus and make changes to their physical spaces and floor plans to comply with the current social distancing and health guidelines. But despite tenants being able to return employees to their offices, most companies have been cautious in bringing back employees on a large scale. Some companies have formulated a staggered work schedule with employees only working 2 to 3 days in the office to reduce the number of employees together in an office at any one time. Many companies have announced that their employees will be permitted to continue to work from home for the foreseeable future, while other companies are considering entering into leases for smaller satellite office space to reduce commute times for their employees on public transportation. Despite the widespread acceptance of employees working remotely as a result of the pandemic, office space – particularly in certain major metropolitan areas, including New York City – should remain necessary. Even after announcing that it will allow most of its employees to continue to work from home until Summer 2021 while others may work from home permanently, Facebook's recent signing of a lease at the Farley Post Office for 730,000 square feet of space, which is in addition to the 1.5 million square feet of space they leased at Hudson Yards last year, is a vote of confidence that office properties will recover in a post-COVID world. There are benefits to employees being together in an office – namely, creativity, collaboration and the presence of a collegial work space. In addition, many employees are likely going to be more willing to return to the office once mass transit safety concerns are addressed and schools are open full time.

While the COVID-19 pandemic will have long-lasting implications on the future of commercial real estate which are difficult to predict, the pandemic has had an unparalleled impact on the way we live and work. These changes have forced property owners to rethink and adapt their properties during the immediate recovery to take into account health concerns, social distancing requirements, safety protocols and mass remote working, all at the same time.