Post-Pandemic Real Estate Market Changes and Opportunities

The COVID-19 pandemic has fundamentally altered the way in which commercial real estate will be developed, built and used. Prudent real estate owners, developers, property managers and builders (and the lawyers who represent them) need to recognize this changed environment and proceed accordingly.

COVID—19 Caused Change in Certain Market Segments and Functions and Exacerbated Already Existing Trends

Certain post-COVID market segments and functions are irrevocably impacted. There are obvious examples. How we shop, when we travel and where we stay have all been impacted. So, space devoted to retail, food and dining, hospitality and transportation all look different. For nearly a year, certain segments – for example, restaurants and hotels – were crippled. What is clear is that real estate ownership, development, management and construction will be different than before.

Looking forward, for certain commercial real estate markets, different means contraction. Shopping in stores – particularly single or focused retail functions – will lessen and diminish. Space devoted to these purposes or massed for retail focus like traditional shopping centers are lessening in demand.

In many segments, change has been good. Online shopping has transformed how we buy things and how we receive them. Space where goods can be distributed are growing in demand. For a state and a region like Indiana where logistics is important to the economy, some of these changes present commercial opportunity.

What has been disconcerting is that the COVID-19 pandemic accelerated certain trends. In housing, above the line, there is a dearth of available housing and in certain upscale markets, available stock is scarce and appreciating in value. Luxury and vacation home building and buying is on the upswing. At the same time, COVID-19 exacerbated an existing affordable housing crisis, revealing a lack of available adequate housing stock and resources accessible for low-income tenants and the landlords and property owners who rent in this market segment.

Office usage in central business districts has gone down and, in some areas, this drop may be permanent. It is not yet clear how post-COVID impacts on commercial office and retail use will affect residential housing in downtown and central business districts. However, it is fair to predict that growth of this market will at least slowdown in the near term.

Related to this point, the COVID-19 pandemic disrupted real estate supply and demand to a greater extent than any other time in recent memory. In some market segments, there is much more available real estate than there is a market. Commercial office space and the ways in which we work are in the midst of a fundamental shift. One recent commentator observed that, in certain markets, Class B office space is effectively obsolete and that there is no current demand for aging and more modest tenancies for now or the foreseeable future.

Evolution and Innovation in the Market

The pandemic has also spawned change, evolution and innovation in the market. So, more changes may be on horizon and sooner than previously expected. More digitally enabled and designed productivity will impact how space is designed and used. Many organizations are looking to change their physical footprint. According to one commercial real estate pundit, many employees will return to their workplace, but not for five days each week. Working remotely – at least part of the time – will become much more standardized. Employers will encourage or at least tolerate more "hoteling" where employees share workspace. More organizations are also concluding that common, open areas are unneeded – at least to the extent that such space is presently allocated. Similarly, COVID-19 also revealed that certain functions and certain industries – information technology, finance, and insurance – may not need centralized office footprints at all, so long as productivity remains stable or improves in a remote work environment. This reduction in office usage may in turn have a cascading effect, as central business district residential leasing is reduced, affecting the retail shops and restaurants which rely on the office worker and the downtown resident. This could also affect mixed-use developments in suburban areas that promote a work/shop/play living model.

Changes in Management and Operation of Real Estate

The pandemic changed how property is built and managed*. Building, sourcing and supplying are more complicated, so building, operating and managing are more challenging. COVID-19 exposed how vulnerable many supply chains are to unanticipated structural disruptions. Supply chains were impacted in ways that will just begin to manifest themselves in 2021. Many organizations discovered unanticipated needs to begin stockpiling materials integral to operations. The impact of these disruptions has not even begun to be fully realized.

The pandemic ushers in a new period of increased financial uncertainty in several respects, all of which impact commercial real estate. While the last recession in 2008 arose because of financial indiscipline, COVID-19 changed how we live and how society operates. There is much uncertainty about basic economic assumption – perhaps, most fundamentally, how much real estate is worth now and what it will be worth in the future.

Compounding this loss of certainty, the government is intervening in the economy in an unprecedented way during peacetime. Trillions of dollars are being introduced in various forms of pandemic relief and economic stimulation. While the investment will be welcomed in many circles, it adds additional unfamiliarity to an already uncertain financial environment.

What implications do these changes have for lawyers who advise clients regarding real estate and real estate impacted or related issues?

Flexible Interpretation, Application, and Enforcement of Contracts

There is no certainty in predicting what the new environment following COVID-19 will bring to real estate law, but flexibility will certainly be one of the hallmarks. Owners and developers may need to convert existing projects to a different tenant mix and to include more restaurants, entertainment and retail office space as opposed to traditional retail tenants. Some buildings may have their uses changed entirely, such as converting office or retail space into flex space, storage or even industrial space.

Such a change in use, however, will require close examination of private covenants and declarations, as well as zoning commitments and other land-use restrictions, governing the property at issue. This, in turn, could require renegotiating existing private agreements so that the owner of the larger shopping center or project has assurance that changes in use of an individual parcel will not materially affect the value of the project as a whole. For example, in exchange for a change of use to flex space, the owner may agree to upgrade the exterior appearance of remodeled space.

A change in use will also apply to future developments. Both project developers and end users will be aware of the difficulty to declare a particular parcel will always be used for retail, residential or office, for example. The ability to convert to other uses as opportunities arise may be the difference between a successful and an unsuccessful project. Lawyers representing successful real estate actors in the future, therefore, must be careful when drafting declarations, easements, and zoning commitments to allow as much flexibility for the client as possible, so that adjustments can be made for the unpredictable future.

Changes in Leasing

While it is too early to tell with any certainty the full effect of the pandemic on office leasing, real estate leasing markets may likely see reduced demand – at least in certain segments as some tenants reduce their footprints and other tenants determine that they do not need physical office space at all. Reduced or eliminated office space may provide the opportunity for stable tenants with long-term office needs to extend and renegotiate the terms of their current leases in exchange for more favorable terms. Renegotiations may be reduction in the space leased or tenant incentives such as free rent or build out allowances. In lease markets with more supply than demand, there may be opportunities for tenants to seek lower rents or more tenant incentives over the next several years.

Changes in Drafting Contracts

For most lawyers at this point, there are provisions that no one would have thought to include in an agreement in early 2019 that must now be considered standard lease provisions. For example, clarifying how a pandemic or similar health event works as a *force majeure* and whether that extends to the duty of the tenant to pay rent is no longer an academic question. Leaving those terms ambiguous after the pandemic is, in many instances, at least a problematic drafting mistake.

Similarly, leases may need to contemplate whether a tenant is afforded rent relief as a result of government shut-down, a partial shut-down or even in a case where the tenant elects, for the safety of its employees and invitee, to suspend operations. A tenant may desire flexibility in the use provision of a lease if its current use is materially affected by the pandemic. The allocation of government relief following a shut-down or disruption of business may also have to be considered in post-pandemic leases. The final form of these provisions will, as always, vary from document to document depending on a number of factors, including the relative negotiating strength of the parties involved. However, lawyers representing parties in real estate agreements need to consider and to address these issues in transaction documents in the future.

To Evict or Not to Evict

The volatility and uncertainty caused by COVID-19 toppled certain assumed truths surrounding real estate. The pandemic taught that it is possible for real estate to substantially diminish in value seemingly overnight. In an environment with new risk, lawyers need to recognize and assist clients proactively to a degree not necessary in the past. Revaluation for creditors and vendors may be more customary and, in many instances, should guide a different approach to interpreting and to enforcing contract rights. Evicting an underperforming tenant makes less sense if there is no replacement tenant on the horizon. Enforcing obsolete valuation assumptions may be unrealistic and counterproductive. As paradigm uses and values shift, property owners, lenders, managers, tenants, and vendors will have to embrace a flexible approach in precarious and unpredictable circumstances.

Value Opportunities Created by COVID-19

For clients who own real estate in Indiana, volatility and uncertainty create opportunity. Property owners who hold real estate that no longer retains the same value can mitigate the impact by contesting property tax valuation. For real estate built for increasingly obsolete purposes, repurposing space, which entails legal issues around rezoning, remodeling and remarketing space, will be imperative. However, it is critical to understand the process and modes of valuation. Much value can be realized by prudently contesting obsolete values based on outdated value propositions.

Changed Realities in Real Estate Construction

In construction around commercial real estate, then, there are a number of new opportunities and challenges. Design and construction around reconfiguring and rehabilitating existing space will be more common. So will demolition and reconstruction of property that, until recently, seemed to have more useful life. Constructors and contractors will need to plan for more supply disruption than previously contemplated, which could make the cost of building more expensive than before unless the parties develop new creative ways for assigning the risk of delay because of material disruption. As a countervailing force that may offset supply cost increases, automation in construction and in buildings will continue, but likely at an increased pace accelerated by the pandemic. And lawyers will need to advise clients regarding all these opportunities and challenges and draft contracts that contemplate these new realities.

Strategic Thinking

COVID-19 introduced uncertainty, which itself triggered the need for more careful strategic thinking and advice to clients. The pandemic revealed the need for many businesses to reconfigure how they do business as well as a pretext for change. But that comes with legal complexity. For example, supply chains are rebalancing and shifting. For many real estate related businesses, that requires fundamental reorganization and redefinition of contractual relationships. Among other things, organizations must plan for disruptions and unexpected delays. Clients need to be advised to plan more conservatively.

The new post-COVID-19 world in commercial real estate presents opportunities, but new risks lurk on the horizon, too. The possibility, indeed likelihood, of funding from unfamiliar sources like the federal government is positive as a spur for activity and development. However, using federal money comes with, at times, unfamiliar risks like the False Claims Act and the False Statements Act. Pandemic stimulus funding and a change in political administrations has already spawned a dramatic uptick in whistleblowing around improper practices in real estate construction, management and operation. Sensible real estate owners, developers and managers and the lawyers who counsel them need to be aware of these changes, too.

The changes brought on and accelerated by the pandemic are a reality in 2021's real estate market. The success or failure of many actors in the real estate market will turn on the ability to recognize and embrace those changes. And lawyers will play a central role in addressing these new-found challenges and opportunities.

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