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COMMERCIAL REAL ESTATE
DEDICATED TO HELPING TENANTS

I COULDN'T PAY MY LAST RENT PAYMENT DUE TO COVID-19... WHAT NEXT?

HOW DO WE FLATTEN THE CURVE OF BANKRUPTCIES?

Needless to say, both tenants and landlords will have some very challenging decisions in the months ahead.

Most retail, service and restaurant tenants ("RS&R's") were unable to pay April rent due to cash flow restrictions associated with the collapse of sales.

As governments and medical authorities continue to advocate consumer isolation, RS&R sales continue to decline and/or flatline for those that are closed.

Fortunately, the majority of landlords, creditors and suppliers are working collaboratively to defer rents, fees, payments and costs. This said, many food delivery services, key product suppliers and insurance companies are not deferring or abating costs which results in a financial hole that deepens by the day.

Even with deferrals, the common expectation is these expenses (rent, royalties, utilities, taxes, debts) will be repaid within a specified time period on top of the expenses/operating costs that will be due during the payback period.

Simply put, this will be impossible for many businesses given sales are not expected to fully rebound for some time and many were already struggling prior to the pandemic*.

In fact, difficult conditions are likely to persist for some time due to what is expected to be the highest unemployment levels in history. Several recent surveys have indicated an alarmingly high percentage of small businesses and restaurants never plan on reopening.

As unemployment levels skyrocket and the shutdowns continue, **a shift from deferrals to abatements or receivable forgiveness will be needed to save a significant amount of companies to flatten the curve of bankruptcies.** This in turn, should help landlords flatten the curve of vacancies as well.

Historical data tells us that:

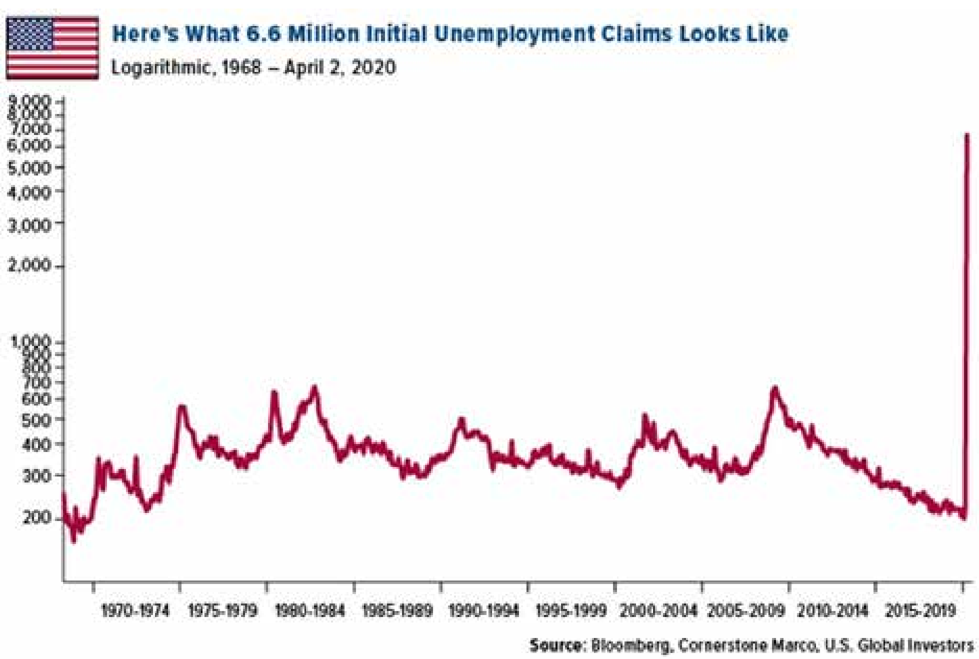
VACANCY RATES:

A) Follow and correlate directly with the unemployment rate; and

B) Are typically within 2 - 3% of the unemployment rate; and

C) Typically lag behind the unemployment rate by 3 - 6 months.

While this is US based data, the principles remain the same for Canada. Notice that vacancy was close to 12% in 1991 when unemployment peaked at 7% which was similar during the financial crisis in 2011. In March of 2020, unemployment claims rose by over 1 million in Canada and 6 million in the United States which shatters all previous records by a substantial multiple. Most experts believe these claims will continue to rise and culminate in nationwide unemployment levels that are likely to yield the following scenario*:



*The longer the shut down, the more likely the graph on the following page unfolds. As outlined in our previous emergency white paper, most RS&R tenants have between between 14 – 45 days where deferrals must be replaced with abatements / longer term restructures.

Source:
1. CBRE, Retrieved on April 17, 2020 from: https://www.cbre.ca/en/research-and-reports/Calgary-Retail-MarketView-H2-2019
2. Statistics Canada, Table: 14-10-0096-01
3. Projection by Orange Group Commerial Real Estate Inc.

WHAT MANY PRUDENT LANDLORDS ARE LIKELY THINKING:

Other than “oh shit!”, many prudent landlords are collectively prepping their lenders and working on loan deferrals as well. But given that deferrals yield the same dilemma as tenants where the debt payments cannot be reasonably compressed, loan write-downs will likely be needed. As we stated in our previous white paper, it is the governments’ responsibility to protect BOTH tenants AND landlords from bearing the financial brunt of this pandemic.

Certainly some landlords will demand rent regardless of a tenant being forced to close as "policy" but this could have some dangerous implications. Attempting to force tenants who cannot pay will yield predictibly poor results (aside from destroying any type of future relationship).

Attempting to backstop the interruption of cash flows could backfire especially since lenders are often the recipients of substantial government support - thereby leaving landlords caught in the middle.

Other property owners will look to pass the buck and look to lenders for the same type of consideration and cooperation as they are giving their tenants to survive and pay rent another day.

As part of working with their lenders, landlords will likely need (and want) to triage their tenants to determine which ones are healthy enough to survive with assistance. It will also be prudent for them to determine which will not survive regardless of assistance in order to preserve their valuable funds / availability to keep the strong alive.

If you are amongst the top performing businesses in your category, chain or sector with reasonable prospects of recovery, it is important that you demonstrate your abilities and stengths to your landlord. Most landlords recognize that it is better to work with a good company to keep it alive in order to draw future rental payments than force an issue and collapse the company where no future revenues are possible. With vacancy rates that are expected to hit the 25% range (or higher for spaces less than 10,000 square feet), the current data suggests that there will be very few replacement tenants available. To ensure operating expenses and property taxes don’t burn a hole in their pockets, a rational approach will typically be taken so everyone can get through this together.

KEY RECOMMENDATIONS FOR RS&R TENANTS:

BUILD A STRONG BUSINESS CASE

If at all possible, make yourself an attractive rescue prospect. This starts with a high level of communication and collaboration with your landlord. If you are a good operator, have a good track record, are (or have been) at the top of sales volumes for your chain, industry or sector – these need to be highlighted!!!

REDUCE EXPENSES

Obviously, cut all non-essential costs and take advantage of every government program available and take every possible step to combat the current conditions. If there was ever a time to invest in a good accountant, advisor or real estate consultant – now would be it.

NEXT STEPS

Work with your advisors to reasonably determine cash flows through a few different scenarios. At this point, 3 months, 6 months and 12 months is probably prudent. Provide your landlord with these forecasts along with detailed steps you are taking to mitigate the current situation to help your business.

Work with your advisors to develop a system wide (portfolio wide) course of action to determine what reasonably can be paid in terms of rent during the recovery period. Most prudent RS&R firms are pulling in their accountants and legal counsel to collaborate with their real estate advisors who will then commence lease restructure negotiations. Every landlord, situation and circumstance is different so a dedicated real estate advisor who is looking out for your best interests is critical.

IMPORTANT DISCLAIMERS

ABOUT US

Orange is a business advisory firm that focuses on real estate exclusively acting on behalf of commercial and office tenants. We partner and align with companies where location, position, and rent have a tangible effect on financial performance. Our mission is to assist our clients to achieve their corporate goals through real estate.

Orange combines innovative thinking with industry leading programs, processes, analysis, and experience to ensure our clients obtain and maintain great locations at favorable terms.

Please visit our website at www.orangegroup.ca or contact Han Kim at hkim@orangegroup.ca for more information.

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