

Gimme Shelter: Can Commercial Tenants Dodge the CRE Ticking Time Bomb?



*Advisors to CFOs,
Management & Boards*

The U.S. commercial real estate market appears to be facing a potentially debilitating time bomb with a \$1.5 trillion fallout and a 24-month fuse. Many middle-market and smaller commercial tenants could get caught up in the ensuing blast, warns Andrew Zezas, Strategist & CEO of Real Estate Strategies Corporation, a New Jersey-based corporate real estate advisory and transaction services firm. But forward-thinking occupants who plan ahead may be able to avoid the carnage, he adds.

FOREVER LOANS — UNTIL THEY AREN'T

"Commercial real estate loans are often known as 'forever loans,' since landlords typically never pay off what are frequently interest-only loans — until they sell the property — instead typically rolling them over every five to seven years," explains Zezas, Strategist & CEO of Real Estate Strategies Corporation, who also serves as Host, Publisher & CEO of *CFO Intelligence* magazine. "But in this cycle, the refinancing process may not be so simple, given the turbulence in the office market as remote employees balk at return-to-office mandates, driving companies to reduce their footprint, and occupancy rates plummet. The question is this: if landlords cannot secure replacement loans on viable terms, will this cause more building bankruptcies and drive other landlords to return their buildings' keys to the bank? That is already beginning to happen. Many commercial tenants believe that their leases will shield them if the above occurs, but unfortunately, that may not always be the case."

It's not a theoretical question. The recent national office vacancy rate has jumped to nearly 18%, a 30-year high, while some individual markets, like San Francisco, are already at nearly 30%. These kinds of vacancies can make banks hesitant to refinance existing loans, especially given the Fed- and bank shareholder-driven tightened credit environment, positioning many properties for possible bankruptcy, sale, or other circumstances and, subsequently, new landlords.

Specifically, in bankruptcies and foreclosures, the lender, trustee, or new landlord may no longer be obligated to honor certain commercial leases, warns Zezas. "Generally, the only time a commercial tenant will be protected in situations like this is if the lease contains a 'non-disturbance agreement' (NDA) — a separate agreement between the lender and tenant ensuring that a lease agreement will continue 'undisturbed' even post-bankruptcy or foreclosure."

The best time to secure such a clause is when a lease is initially negotiated, counsels Zezas, "since that's when tenants typically have the most leverage. Enterprise-level companies, which generally have qualified internal and external legal advisors protecting them, will usually negotiate an NDA agreement as part of the initial lease negotiations. But middle market and smaller companies may not be familiar with this form of protection and, unless they're advised by knowledgeable real estate advisors or other experienced strategists, will frequently not pursue an NDA. When I recently asked the real estate executive at a Midwest based retailer what percentage of his company's real estate portfolio contained NDAs, he went silent and didn't know the answer."

One obvious question tenants ask is why a new landlord would even want to boot an established commercial tenant, especially one with a track record of on-time lease payments. "There are a host of reasons," says Zezas. "The new landlord may want to secure a new, higher-paying tenant; they may want to knock down the existing structure, or pursue other alternatives. But regardless of the reason, if the commercial tenant doesn't have an NDA in place, they're likely to be out of luck."

Andrew Zezas

Strategist & CEO, Real Estate Strategies Corporation

Zezas says it's easy for companies to slip into this kind of risky position. "I've seen numerous companies that start out small, where the company's original owner also owns the building it occupies. Then, when another company buys the business, it may enter into a simple lease with the building owner (original business owner) that does not contain an NDA. Or the original owner may have created a lease between his or her business and building, and the new purchaser would take the business subject to that original lease — which may not contain an NDA — and the original business owner would become the purchaser's landlord, putting the new business owner/tenant in a risky position, without an NDA."

In an M&A, back-of-the envelope leases, like those frequently created between business owners and their owned buildings, can be risky.

The challenge, he adds, is that these kinds of "back-of-the envelope" leases often do not contain non-disturbance provisions, "simply because the original owner didn't need one," Zezas cautions. "He or she owned the business and building, so there was no need for a sophisticated lease or an NDA. However, when purchasing a business with a simple lease, the new business owner could be at risk if the original business owner/new landlord runs into financial difficulty later on, and the building enters bankruptcy or otherwise."

Zezas has some suggestions for commercial tenants who may soon be facing a cliff as their landlords' underlying mortgages expire. "Start by reviewing all of your company's lease agreements," he says. "Confirm whether NDAs exist and are in-force for each leased property, as some NDAs are not evergreen and may expire, or could no longer be effective for various reasons."

But, if the NDA, in any lease, has expired, "the tenant should ascertain whether the lease contains renewal rights to ensure that the occupant will have long-term control over its premises, and may wish to consider extending the lease and negotiating a new NDA with the landlord and lender," Zezas continues. "Also, if the NDA is still valid, the tenant or the company's real estate advisor should determine whether or not the landlord has the right to accept or reject the lease extension."

If it appears as though the tenant does not have an NDA in place, "commercial occupants may wish to identify how close the landlord's debt on the underlying property is to its expiration," he counsels. "If it's not for a few years, and if concern exists about the landlord's ability to refinance, tenants may wish to attempt to secure an NDA. But if that fails, you could instead use the time to look for alternate facilities and — when you find another property that meets your company's needs — negotiate an NDA before you sign a lease at the new property. In seeking positive outcomes, an experienced corporate real estate advisory and transaction services firm can offer valuable guidance in protecting your company's real estate and business interests."

