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Q&A with Goulston & Storrs' Jean C. Bowe and Brian M. Cohen on "Reimagining Real Estate"

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Jean C. Bowe and Brian M. Cohen

*In this Q&A series, "Reimagining Real Estate," **Brian Carrozza**, Associate Director of Strategic Growth at Goulston & Storrs PC, sits down with attorneys from the firm's market-leading real estate practice to talk about how they see the pandemic reshaping commercial real estate in 2021 and beyond. This month, he spoke with **Jean C. Bowe** and **Brian M. Cohen**, real estate directors and leaders of the firm's Office Industry Group, about what landlords, tenants, investors, developers, financiers, and managers should know regarding the current and future state of the office market.*

Q: How does supply-demand balance look one to three years down the road?

Cohen: This is one of the most significant and pervasive questions that has emerged from the pandemic in commercial real estate. The office asset class is undergoing a watershed change that will continue to cause many corporate occupiers to reexamine their footprints, and as such, uncertainty around how things will play out remains high. Very few organizations will return to pre-COVID patterns and practices, and 2021 will likely be a year of inflection for the office sector.

The future of the office supply-demand balance is nuanced. Even some of the businesses that have

announced long-term work-from-home plans are simultaneously building new headquarters or signing new leases. Space planning has evolved to address social distancing in the workplace. Many occupiers have taken a wait-and-see approach to longer-term real estate decisions as they determine how to balance remote and office work; the consensus among many people seems to be that both too little and too much remote work are suboptimal. There are other factors to consider as well, including: health and safety, commuting patterns and public transit, floor-plate and building configurations, long-term leases, and talent management (training, recruitment and retention).

Q: What are some key takeaways on the Boston office market in recent months?

Bowe: For the past few months there has been a good amount of uncertainty in Boston, and a slowdown of many new deals, while companies paused and continued to examine what their return-to-office approaches will look like. More recently, however, the number of tenants now forging ahead with new deals and extensions has increased. Many owners of Class A, multi-tenant office buildings in Boston were typically well-positioned before the pandemic, with relatively low vacancy rates, and many tenants continued to pay rent throughout the shutdowns and remote-work environments. So, many of those owners were not in a rush to make deals quickly, and have taken a longer-term view of how to manage their vacancies. Many tenants also still have sublease space on the market in an effort to offset the cost of excess space, and subleases continue to get signed up.

Q: What are some of the trends you've been seeing in rent relief negotiations and lease modifications between office landlords and tenants? How do lenders factor into these negotiations?

Bowe: In the office sector, rent relief agreements have often been tied to extensions of lease terms. Office landlords have typically been careful to examine an individual tenant's need for rent relief, and the tenant's type of business is still a big factor in terms of whether a tenant is granted rent relief. From what I've seen, deferrals of rent have been more common than straight rent abatements. Some tenants have chosen to downsize either as part of an extension of their lease term or as part of a rent relief package. Others have given up certain options in exchange for rent relief. In my experience, lenders have been rather deferential to landlords in the multi-tenant context, particularly since in many cases there is not a significant effect on asset cashflow.

Q: What kinds of new office deals have you been seeing in the pipeline? Are there thematic commonalities between them? What kinds of deals have you not been seeing?

Bowe: Most office deals have been coming out of necessity as tenants are forced to decide if they should renew where they are or move to a new location. Some companies—particularly startups and those in industries that have grown during the pandemic—have been expanding or looking for new space. Despite the uncertainty surrounding return to work, I have not been seeing options for tenants to terminate space early or give back space if they overestimated their needs.

Q: Early on in the pandemic, we saw many lenders on office properties “kicking the can down the road” on debt service, allowing significant periods of extension and forbearance. To what extent has this pattern changed in recent months as vaccination rates increase and the country begins to open up again?

Cohen: I believe the conversation between borrowers and lenders (and landlords and tenants as well) is different today—and perhaps also more challenging—because there is an appearance of improvement but a delay in economic recovery. The good news is that there is more certainty (i.e., fewer variables) in

negotiations. Parties generally understand that vacant space needs to be re-tenanted and that funds will be required for tenant improvements and leasing commissions.

Office owners may be looking at their retail/restaurant spaces differently today than pre-pandemic. Potential office tenants want to see a building with active retail, restaurants and coffee shops for employees. In some cases, landlords will need to continue to effectively subsidize the retail component of their office properties to provide, for example, a restaurant or coffee shop, which is essentially an amenity. Lively streetscapes often translate to more energy in leasing the office property above. These are just a few examples of why existing debt (as modified by extension and/or forbearance during the pandemic) may no longer work for a property.

Many office buildings are properties in transition and require capital for recovery. Borrowers are going to have to be able to bring in a subordinate lender or additional capital to reposition their office properties and make them healthy and profitable again. Now that the country is opening up, borrowers and lenders will need to work together to restructure loans in order to allow for properties to be repositioned in this evolving environment.

Q: What U.S. metros are likely to benefit the most and least from COVID-19's impact on the office sector?

Cohen: New York City office is my specialty and remains a strong long-term growth opportunity for the office sector. Both New York City and Boston will benefit from the ongoing, post-COVID-19 growth of the life sciences sector. In New York, Long Island City—with its large floor plates, room for expansion, excellent access to public transportation (it's just one stop on the subway from Midtown Manhattan), educated workforce, and an ecosystem of restaurants, parks, housing, and schools to support a live-work-play environment—is particularly well-positioned for office sector growth to accommodate life sciences tenants and other national tenants at sub-Manhattan prices.

Another area of growth in the office sector is the U.S. General Services Administration (GSA) market. Properties fully leased to the federal government remained a generally stable investment throughout the pandemic. We have closed a number of GSA office transactions over the past 12 months in markets throughout the country and expect that—as government grows—so will the need for more office space throughout the country.

Q: There is a growing demand for lab space in the U.S., which has led some building owners and developers to explore converting existing office buildings, especially as uncertainty persists around future demand levels and rent growth. What are some of the challenges that owners and developers might encounter when repurposing former commercial buildings into research labs? What factors and threshold questions should they consider to determine whether adaptive reuse is viable?

Bowe: The physical nature of the building should be a top concern. Retrofitting base building systems and achieving a layout to accommodate the HVAC, utilities and equipment for life sciences and laboratory tenants can be very expensive, and in some cases, a building's design or layout can make some of these parameters nearly impossible to accommodate. Moreover, if a building fails to secure lab tenants altogether (or at expected rents), these improvements are not easily repurposed for other types of tenants.

Many smaller lab tenants, startups and emerging companies are looking for landlords to provide turnkey buildouts and manage the real estate side of things so they can focus on the science that lies at the core

of their businesses. Office owners will need experienced advisors to manage laboratory designs and buildouts in order to compete for those tenants, and will need to move quickly to get them online and operational in the lab spaces.

Q: With heightened vacancy rates putting downward pressure on rents in many CBDs, to what extent are we likely to see a ramp-up in the volume of new leases over the next 12 months, as tenants hunt for bargains? Will there be an explosion in subleasing activity if many companies move to a permanent hybrid work-from-home/office model?

Cohen: In New York City, we are seeing more leasing activity than during the pandemic. Having a strategy-minded leasing broker is key for landlords and tenants in this environment. I have seen brokers bringing landlords with space and capital together with credit-worthy tenants who have remaining term on their leases and structuring deals whereby the new landlord will cover the cost of the remaining lease term at the existing premises. The landlord for the replacement space will then capitalize the cost of the remaining term for the relinquished space in the replacement space lease (similar to the capitalization of tenant improvement costs). This will afford a new, long-term lease with a quality tenant and allow the landlord to restructure or refinance existing debt. In certain cases, the closing of the refinancing coincides with the signing of the new lease, and payment of the cost of the relinquished space. These are complicated deals that take time and capital to structure and bring to fruition.

Sublease provisions in New York City are notoriously complex. The overlandlord consent requirements can sometimes lead to a month or more of delay, which may be compounded by the dynamic of a tenants' efforts to sublease their space in competition with landlords' efforts to lease space directly in the same building. Nonetheless, if a tenant is willing and able to sublet space at the current market rent (which may be well below their actual rent), there could be bargains out there, especially for updated space in good condition. This may sound like a bargain for improved space with a shorter-term lease, but the devil—as they say—is in the details. Can and will the sublandlord continue to pay the higher rent to the overlandlord? Will the overlandlord recognize the subtenant's right to remain in the space at sublet rent if the sublandlord (tenant) is in default under the overlease? If the user (subtenant) is willing to commit to a term in excess of the remaining term of the overlease, a creative broker can inspire a conversation with the owner of the office building to facilitate a recapture of the space by the landlord, a direct lease with the user, and some payments, to cover the difference between the overlease rent and the current market sublease rent. Engaging an experienced lawyer would be well-advised too.

Jean C. Bowe focuses on leasing and financing transactions, complex acquisitions and dispositions, and real estate development. Brian M. Cohen counsels investors, lenders, developers, owners, family offices and entrepreneurs in all aspects of sophisticated real estate transactions and developments in New York City and throughout the country. Brian Carrozza focuses on business growth and practice management, serving as strategic advisor to Goulston & Storrs' Real Estate Group, including by acting as "chief of staff" to the group's co-leaders. They can be reached at jbowe@goulstonstorrs.com, bcohen@goulstonstorrs.com and bcarrozza@goulstonstorrs.com.