The Looming Landlord/Tenant Divide

As recently as early March, landlords in Center City Philadelphia and the surrounding suburbs were sitting on top of the world. They were cutting lease deals and asking for rents that were, in some cases, 30% to 40% higher than what they agreed to just a year or two earlier. In fact, because rents were approaching replacement cost, new construction was viable. Hamilton Lane, Amerisource Bergen and Morgan Lewis, among others, committed to major new office buildings at some of the highest rents ever paid in their respective submarkets. Now, just a month or so later, many businesses are struggling just to survive the COVID-19 pandemic and others are wondering about the future of the office market and whether they will need nearly as much space in the new virtual business world. When landlords and tenants get back to the negotiating tables, their respective views of the market may be miles apart.

HOW COVID-19 MAY IMPACT FUTURE DEMAND

A lot is already being written about how our forced trial of remote working will ultimately impact office space utilization when things return to "normal." While some people believe that workers trapped at home will beg to return to the office once released from the government-imposed quarantine, others believe this forced exile will do to the office market what e-commerce has done to the retail market. Make no mistake, over the long term, demand for office space will shrink. Here are just a few reasons why:

1. Companies will now be more willing to adopt hoteling and, therefore, no longer plan for one dedicated seat at the office for every employee.
2. Many businesses will fail or shrink as a result of this COVID-19 crisis and their excess space will come back on the market.
3. As companies realize that certain types of work can be done remotely without sacrificing quality, some companies will decide to outsource these functions to cheaper labor markets/countries.
4. Co-working, the largest space consumer over the past five years, will contract in a major way. The hyper, global expansion of this industry was not sustainable (or profitable), thousands of clients are canceling or not renewing their licenses and a lot of this space will ultimately come back on the market.

Of course, it's important to note that when it comes to real estate, change doesn't occur overnight. Commercial leasing is a relatively long-term commitment and, as a result, companies may not be able to implement material changes in their space utilization until their current leases expire (or they at least get close). Only then will they be able to shed excess space or reconfigure into more efficient space plans that accommodate the new remote work paradigms. As a result, unless there are major business failures in the short term, it may take years for the foregoing trends to materially impact rental rates in any given submarket.

LANDLORDS' PERSPECTIVE

Almost every economist acknowledges that we are now in a recession; however, this recession is very different. Not only did the economy go from firing on all cylinders to a complete stop, but this change also happened overnight and without warning. No one had time to prepare for this or to adjust their expectations. This sudden, dramatic change in the economy may create a very problematic dynamic when landlords and tenants sit down at the negotiating table to hammer out a long-term lease.

If two parties approach a negotiation with anchored expectations that are completely at odds with each other, the gap is often very difficult to bridge. Is the office market today the same one we saw in early March 2020 when deals were being inked at the highest rents in the region's history, or are we in a recession that will dramatically impact real estate for the reasons stated above? Are we going to see a quick "V" shaped recovery, or will this pandemic related recession drag out for months or years and fundamentally change the way companies consume office space? It is very likely that landlords and tenants will have (or at least express) very different views of the market when they turn their attention to leasing transactions in the coming weeks and months.

HOW WILL DEALS GET CUT?

Ultimately, deals will be decided based on each party's alternatives. The more and/or better the options a tenant has, the more likely it is that at least some of the landlords under consideration will be fearful of the future and will, therefore, act aggressively to fill their vacancies while they can. While landlords may disagree on the long-term impacts of COVID-19 on commercial real estate, any landlord who says it feels as good about the future as it did in February isn't being honest. The office market has a lot more uncertainty than it did two months ago.

Tenants with multiple options should be able to obtain aggressive pricing from competing landlords in the near term. Tenants with fewer options (or who are competing with multiple other tenants for the same space), may not see the immediate movement in rents they were hoping for. While demand for office space should decrease, it will occur gradually as leases expire, deals are restructured, and companies shrink their footprints. We may not see the market soften across the board until landlords start getting back the excess space resulting from the COVID-19 fallout.

CONCLUSION

Because of the uniqueness of this current recession and the speed with which it hit us, landlords and tenants may have very different perceptions of the market and the future of commercial office space when they sit down to negotiate a lease in the coming weeks and months. The key for tenants will be finding landlords whose view of the future is consistent with their own.