the TENANT'S POINT.

Insights from veteran McCall & Almy advisors on the impact of COVID-19 on Greater Boston's commercial real estate market.

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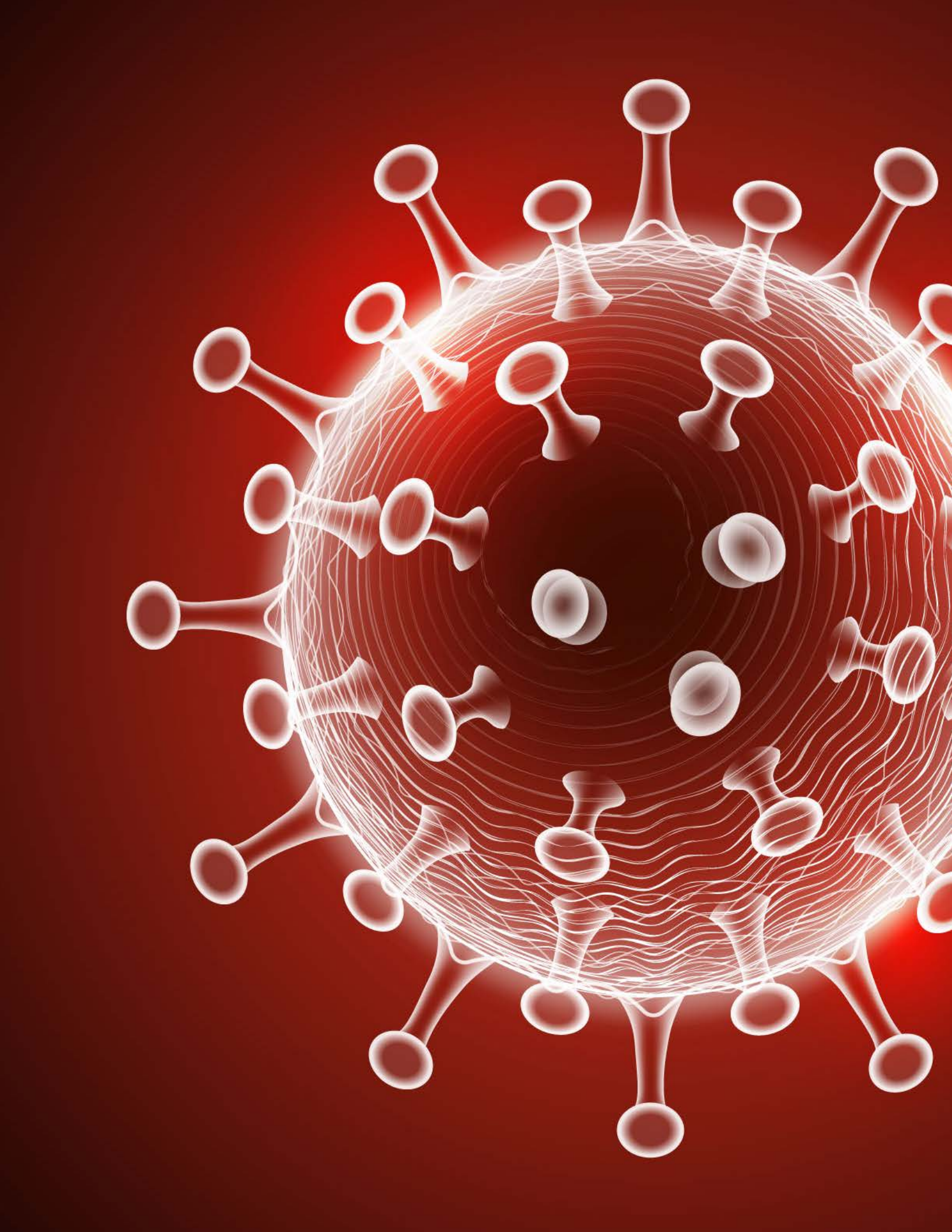

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The COVID-19 outbreak has resulted in unprecedented business situations for all of us. Construction sites were temporarily shut down, non-essential businesses were being forced to suspend their physical operations, businesses implemented, either voluntarily or by necessity, work from home procedures, and the list goes on, not to mention the human toll that this crisis has had.

The sudden change to business operations have left many wondering about the economic impact to not only Greater Boston, but also the global economy. While some believe we will have a V-shaped recovery, our team feels that is wholly unrealistic given it has never happened in the past. What is the state of the market today and how will it impact leasing going forward? What about the status of in-process real estate transactions and whether there are any rent relief provisions included in your lease? While we are facing one of the worst economic downturns on record, as with the Great Recession, Boston is in a much stronger position to rebound than other markets, beginning with its solid "meds and eds" foundation.

The Tenant's Point focuses on the impact COVID-19 has had on commercial real estate, what our outlook on the market will be as a result of the pandemic and understanding your lease in an era of uncertainly.

IN THIS ISSUE.

BILL MCCALL GIVES SOBERING ASSESSMENT OF COVID-19 IMPACT ON CRE.

By Bill McCall

Bill McCall, President

Bill has wisely counseled institutions, corporations and property owners on the valuation, acquisition, disposition and leasing of real estate for 60 years. His decades of experience, clarity of vision and market sense have produced great value to clients seeking independent real estate counsel.

IN HIS SIX-PLUS DECADES IN THE GREATER BOSTON COMMERCIAL REAL ESTATE INDUSTRY, MCCALL & ALMY FOUNDER AND PRESIDENT BILL MCCALL HAS SEEN HIS SHARE OF DISASTROUS DOWNTURNS.

The Great Recession, the aftermath of 9/11 and the fallout from the bursting of the dot-com bubble are still fresh in most people's minds, but he also recalls the OPEC oil embargo of 1973 that quadrupled gas prices between 1973 and 1974, one of the key contributing factors to the 1973-1975 recession.

"It knocked the hell out of our whole economy to the point where in 1974 I went up to New Hampshire to get a broker's license because Massachusetts was just in the tank," says McCall. The latest crisis is of a far greater magnitude, he says, but shares the defining quality of all economic disruptions fueled by outside forces – uncertainty. "With every downturn you have uncertainty. Not just the uncertainty of how long it's going to last, but of the steps we're going to have to take to make it better."

The loss of life brought on by the COVID-19 pandemic in such a short time has been horrific, but unfortunately, it is not without precedent. What is different about this current crisis, however, is how the economic impact differs not only from prior modern-day pandemics, but all previous economic downturns, McCall notes. "You really can't compare this to any of the others," he emphasizes. "Have we ever, ever seen so many people out of work in such a short time?"

According to recent estimates by the Washington, D.C.-based Economic Policy Institute, the unemployment rate may hit nearly 16% by July – higher than at any point since the Great Depression. Over the past month, more than 570,000 people in Massachusetts have filed unemployment claims, according to the April 16 U.S. Department of Labor report. With the total number of confirmed coronavirus cases surpassing 30,000 (as of April 16, with fatalities now exceeding 1,100), and the surge not expected until late April, it appears non-essential businesses will remain closed through mid-May at a minimum.

While some local industry observers have predicted a rapid recovery based on Greater Boston's strong fundamentals (low vacancy, rising rents), traditionally resilient sectors like healthcare and education, and the region's growing life science and tech industries, McCall is not optimistic about a quick rebound for most sectors of the commercial real estate industry.

"I don't think a V-shaped recovery in real estate is realistic," says McCall. "You can have a V-shaped recovery in the stock market, but I'd like them to go through the history books and tell us if there's ever been one in real estate. That just doesn't happen."

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We've always come back. You can go back to the civil war. You can't have much more destruction than a civil war and eventually we came out of that. Then we had World War I and World War II with the Depression in the middle. I really do think things are going to get better and we are going to be in better shape down the road. I just don't think that 'down the road' means September.

As far as the usually reliable economic drivers, both healthcare and education have complex financial and operating issues to contend with. Hospitals and physician groups are losing critical revenue as they shift their focus from more profitable procedures to preparing or caring for coronavirus patients, in compliance with Governor Baker's order to postpone or cancel all non-essential elective procedures. "Hospitals haven't been able to do elective surgery (since March 15) and won't be able to do it for another period of time, so they're getting killed financially," says McCall , who adds that is still unclear what impact tele-medicine will have on revenues until patients become comfortable with office visits again.

The Greater Boston colleges and universities are also in a precarious financial position, as Boston University, the University of Massachusetts system, MIT, and Harvard University are all considering delaying the fall semester, according to a recent Boston Globe piece. Even if the colleges do open in the fall, they stand to lose out on revenue from the summer school sessions, which are typically a financial boon to the schools. "So, the conventional wisdom that health care and higher education are countercyclical may not be true in this case," says McCall.

In the last five years, the primary drivers of occupancy and rent growth in Boston and Cambridge have come not from the old guard – financial services, accounting and law firms – but from technology and life science. While the growth of these companies has been phenomenal, McCall is cautiously optimistic about their continued success during the inevitable downturn. "Although the growth of these industries in this market has been terrific for the region, one of the things you've got to be careful about is that a lot of those companies are not established businesses yet, and to a great extent, they are not making money," he points out. "They are going for growth and hoping and hoping that all of a sudden they're going to be the next Amazon." Many are still heavily reliant on venture capital and angel investors for funding. And with the volatility of the stock market in recent weeks, continuing that funding for an extended period of time could present a problem.

In terms of when he expects Boston to be fully back to work, McCall is in complete agreement with recent comments made by Eric Rosengren, president and CEO of the Federal Reserve Bank of Boston, who stated that it was "going to be some time before the economy is fully recovered." Rosengren said the true test of when the economy is truly back will come when people are comfortable using mass transit, going back to bars and restaurants as well as large entertainment venues. To which McCall adds, "I think the only way this pandemic ends is after substantial testing is in place or the introduction of a vaccine."

McCall often quips that he "is the guy who has predicted eight out of the last four recessions," and despite his sobering look at the pandemic and its effect on the CRE world, he remains hopeful about a long-term recovery. "I really am a bull. You can't be in business for 60 years and not be an optimistic guy," he says. "We've always come back. You can go back to the civil war. You can't have much more destruction than a civil war and eventually we came out of that. Then we had World War I and World War II with the Depression in the middle. I really do think things are going to get better and we are going to be in better shape down the road. I just don't think that 'down the road' means September."

ASSESSING THE BOSTON OFFICE MARKET DURING COVID-19.

By Lenny Owens, David Richardson and Sandy Tierney

Lenny Owens, Executive Vice President

With over 34 years of experience in commercial real estate, Lenny has assisted some of Boston's most well-known companies like Raytheon, Bose Corporation and Putnam Investments, while also managing and optimizing global portfolios for such firms as TripAdvisor.

David Richardson, Executive Vice President

Dave brings over 40 years of experience in commercial real estate advising downtown office tenant clients. He has worked with some of the largest firms in Boston, including Goodwin Procter, MFS Investment Management, Safety Insurance, TA Associates, and Houghton Mifflin Company.

Sandy Tierney, Executive Vice President

Sandy has advised corporate and institutional clients on a broad spectrum of real estate transactions including property acquisitions and dispositions, lease transactions, and more complicated ground lease and sale-leaseback transactions. He has worked on engagements for The Broad Institute, Harvard University, The Roman Catholic Archdiocese of Boston and numerous other mission-driven organizations.

THE UNCERTAINTY SURROUNDING GOVERNOR CHARLIE BAKER'S PLAN TO RE-OPEN THE MASSACHUSETTS ECONOMY IN FOUR PHASES IS A REMINDER THAT ESTABLISHING A TIMETABLE FOR A RETURN TO WORK MAY BE NEARLY IMPOSSIBLE FOR MANY BUSINESSES.

Despite the uncertainty, however, there are encouraging signs that the Greater Boston real estate market can successfully weather the storm created by the pandemic and adapt to a new normal more quickly than other markets.

On a national level, a stock market that had seen all of its gains since 2017 wiped out in mid-March rebounded forcefully (including Boston headquartered firms Wayfair, Boston Beer, and Vertex Pharmaceuticals), although the past week indicated there could be a return to volatility. And while the COVID-19 pandemic has devastated some CRE sectors – particularly retail, restaurants and hotels – others remain strong, particularly industrial, as ecommerce plays an increasingly important role in helping consumers meet their needs while helping them to stay safe.

As for Greater Boston, the diversification of its economy should prove to be its saving grace. The healthcare and education sectors, despite current challenges, will continue to serve as anchors for the economy in the long run, although the delivery systems for both may undergo radical change. The life sciences, which have created huge demand for both lab and office space in Greater Boston in recent years, should continue to thrive – particularly with an increased focus on devising a vaccine and treatments for COVID-19 in addition to their ongoing research and development.

The State of Office Today

The office market, because it represents such a large percentage of commercial real estate, will bear close watching as the impact of the coronavirus continues to unfold. Of immediate concern is the ability of tenants to pay rent and the ripple effects that will be felt throughout the real estate ecosystem. As we are still in the early stages of the crisis, we are advising tenants to have honest conversations with their landlords about their financial situations so that if warranted, a deal that is amenable to both parties can be worked out. In some cases, that means landlords extending free rent for the near term, typically with the understanding that it will be made up on the back end of the lease, and may include extensions. Not all landlords have the financial flexibility to do so however, which could result in a cascading effect as tenants delay rent, landlords default on mortgage payments, and lenders and investors in mortgage-backed securities are adversely impacted.

For tenants currently in the market for space, there has been a pronounced slowdown in lease deals of late, as any tenant that doesn't have to make a decision in this uncertain market is not going to. Those with more immediate needs hoping to gain rent reductions or other concessions from landlords in this market today may be disappointed, however. Unlike previous downturns, much of the Class A office space in the Boston CBD is owned by well-capitalized landlords such as Oxford, Boston Properties, Rockpoint, Norges Bank, and Prudential – which typically take a long-term view.

If the lockdown continues for a prolonged period, however, landlords may no longer be holding all the cards, as the amount of sublet space being released back into the market could be substantial, driving down rents. This may take some time to become reality, but every day we are seeing more and more sublease opportunities becoming available. We could potentially see the vacancy rate in the CBD go from

6.5% to 13%-15% and the suburbs increase from 12% to as high as 20%-23%, in certain markets. Even the well-capitalized landlords mentioned above will eventually need to respond with lower rents.

Currently, tenants with immediate space needs are adjusting their real estate strategies. In one case, a company with plans to take 50,000-plus square feet prior to the coronavirus re-assessed and opted for a deal for two-thirds of the space, benefitting both the tenant and landlord in the short term. A second tenant planning to renew for five years worked out a deal with the landlord to reduce the commitment to two years, but paid a premium for the shorter term.

What's Next?

When office buildings do open their doors, the way that office space has been used will undoubtedly change. For starters, the coronavirus has created a massive test case for the viability of work-at-home strategies for both companies and employees. While there will almost certainly be an uptick in the amount of people working from home for at least some portion of the work week, it appears there is a significant portion of the workforce who feel they can be more productive in a structured work environment.

While there is much speculation as to what the future of the post-coronavirus workspace will look like, the trend towards work benches is likely to go away and the current 110-180 square foot per person allotments are going to increase. Business is becoming increasingly global and health experts are predicting that epidemics of infectious diseases are expected to become more prevalent. With this in mind, many of the larger requirements in play today are re-assessing their space needs and are now planning to increase the ratio from an average of 130 square feet per person to a minimum of 200 square feet and up to 300 square feet. So while work from home strategies may reduce the daily headcount in the office, the need for spacing should keep office space requirements from contracting too dramatically. This may also spur the need for companies to take lower-cost space in the suburbs, particularly for support functions.

The move to the suburbs is a trend that may occur regardless of COVID-19, as millennials having children begin to consider moving to the suburbs seeking less expensive and larger living space for their growing families. A prolonged COVID-19 situation in a congested city with less access to nightlife and cultural events may hasten the move to the suburbs.

While the City of Boston has not announced a firm date for nonessential construction to resume, speculative office construction will largely come to a halt. This includes projects such as Boston Properties' Back Bay Station as well as South Station, although Hines and co-investors Dutch pension fund APG Asset Management U.S. Inc. and New York-based Dune Real Estate Partners may have the deep pockets and long term vision to proceed with South Station. Projects with a tenant already in tow – including the 1.1 million square foot Bulfinch Crossing, which pre-leased over half of the office space to State Street – should continue, as will multifamily projects throughout the city. Demand for startup spaces could be affected, as the pandemic is presenting challenges for a number of startups. Venture capital is becoming scarce, although funding for some biotech and cybersecurity firms will continue.

The Good News

As with the Great Recession, Boston is in a much stronger position to rebound than other markets, beginning with its solid "meds and eds" foundation. Colleges will transition to a teleconferencing model for the short term as the virus continues to take its toll on our people and institutions, but will ultimately survive. The high density of world-class educational institutions creates a fertile talent pipeline as well as fueling tech and life science startups that may become the next Facebook or Biogen. There is also a pent-up demand for medical services (including elective surgeries, a vital moneymaker for hospitals), so the healthcare industry should come back strong once the healthcare settings are deemed safe enough to return to.

Boston's diversified economy, fueled by its growing tech and life science industries and anchored by traditional businesses such as financial services and law firms, will survive. When we emerge from this pandemic, the world will be a different place, but Boston will continue to be a hub of culture and innovation.

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UNDERSTANDING THE LEASING ENVIRONMENT IN AN ERA OF UNCERTAINTY.

By Jennifer Elia

Jennifer Elia, Senior Vice President

Jennifer has over 20 years of experience focusing on a wide range of lease administration services to provide our clients with accurate lease portfolio data and reporting. Her legal background and expertise reviewing commercial leases give her a broad understanding of market standards and how the business terms of a lease can impact a client's tenancy.

What has been the reaction of tenants to the pandemic?

When COVID-19 first broke and everything shutdown, the general reaction was some level of panic, which was understandable. Office tenants were thinking, "I can't go into my space, the economy is going to go south, what's going to happen to my business, etc.?" And I think that's a natural reaction. The main questions that followed seemed to be, "Can we get out of our lease?' and "Can we stop paying rent?"

I went through the dotcom bust in the early 2000s, and the "I just want to stop paying rent" reaction was similar. Well you can't. It's a contract for a significant amount of money and you can't just ask for a do-over. As time has gone on, people have realized that this is a long-term issue and it's going to impact all of us in some capacity – but the world is not going to end.

What about force majeure?

The force majeure clause will not generally protect tenants against their obligation to pay rent. Right before the shutdown occurred, we were already being asked to check leases for force majeure language. That language protects one or both parties from having to perform certain obligations under their lease in the event of unforeseen circumstances that are beyond a party's control. The force majeure clauses we've seen are very specific as to what type of circumstances are covered and which party or parties it protects. They all have different levels of specificity, and typically all state that the tenant is still obligated to pay rent. One clause I recently reviewed that specifically addressed a pandemic also stated the tenant had to pay rent – so even a tenant who specifically addressed the issue was still obligated to pay their rent.

It's also important to remember that most of the office buildings have never officially closed. They were fully operational, and it was the government, and subsequently employers, that advised employees to work from home. Buildings are still being cleaned and security is still onsite. And if the building remained open, then why shouldn't landlords be able to collect rent? The flip side to that is some tenants are still thinking, 'I'm not using my space, why am I paying for it?'

How are tenants and landlords resolving the rent issue?

Some office tenants are requesting some form of rent relief. I haven't heard about very many landlords agreeing to simply forgive rent for X amount of months, but most are willing to offer some level of deferral with the understanding that the lease term will be extended for that period of time – rent relief now with payment on the back end. But it is on a case-by-case basis depending on the tenant's situation, i.e. whether or not the tenant is truly financially impacted by the shutdown.

On the landlord side, much depends on how heavily they are leveraged. For many landlords, if tenants don't pay their rent, then they can't pay their lenders. So that leads to the question of whether they have debt on their building. If the answer is 'yes', then what type of relationship do they have with their lender? If the landlord is well capitalized, it has more control over whether or not it can offer some sort of rent relief, but then there's the question of how it will impact their P&L for the year. Right now, many landlords seem to be in secure financial positions with minimal debt

on their buildings – especially the large institutional landlords – but a discussion needs to be had so both parties can understand one another and find a mutually beneficial solution.

I should also emphasize that tenants need to initiate these conversations and be prepared to be fully transparent. Landlords are unlikely to proactively encourage tenants to stop paying their rent – that would be a first. In our experience, and mind you it's only been a few months, landlords are typically willing to work with the tenant as long as the tenant is forthright in terms of the financial impact the pandemic is having on their ability to pay rent.

Should tenants expect to assume additional costs related to the pandemic?

That remains to be seen. As an example of an event impacting costs, after 9/11 there were a lot of questions with regard to insurance costs, which went through the roof. Those costs were passed through to tenants, and it was a big financial hit initially. All of a sudden, we were negotiating specific language to address an expense that was the result of a very specific event. Tenants were not comfortable with it at first, and it took some convincing to get them to understand it was fair. As time went on, that language became standard because tenants grew to understand the landlord's position, given that it was a very specific occurrence that happened and the 'what if?' factor still remained.

I do think we're going to see some changes in the leases going forward because I expect operating expenses are going to go up, but only time will tell if it's for the short term or long term. When the pandemic hit, some clients may have thought, "My expenses should start going down. We're not in there, so I don't expect to be paying as much." And while it may be true for something like electricity within their space, expenses like cleaning are most likely going to increase, given that it will be occurring more frequently due to COVID-19. Some buildings will also be setting up temperature checks in the lobby so that anybody with an elevated temperature will be denied access to the office. I'm sure there will be more information emerging in terms of how the virus is spread, and as more science-based information becomes available, we may see an impact on the costs if, for instance, major filtration upgrades to HVAC systems are necessary. Unfortunately, because of all the variables at play right now, it's impossible to know with certainty what's going to happen.

What should tenants be focused on right now with regards to their lease(s)?

Right now tenants should focus on understanding their current lease(s). They can ask their real estate advisory firm to assist with that, but should first make sure they have executed copies of their leases and any related documents (amendments, estoppel certificates, commencement date letters, SNDA's, etc.). Tenants should also request an abstract of their leases. If your real estate provider has a lease administration team, even better, because they typically review hundreds of leases a year due to the nature of their jobs and are able to see market trends regarding lease language and what types of costs landlords are passing through to tenants. The abstract will provide a tenant with an accurate summary of the terms of their lease, including financial obligations, i.e. base rent, operating expenses, and taxes. It will also include the tenant's rights as far as term extensions and termination options, maintenance and repair clauses, etc. We're seeing that landlords want to work with their tenants, but it's up to the tenant to show the landlords they've been fiscally responsible and that they understand the rights they have under their lease if they're looking for some form of rent relief.

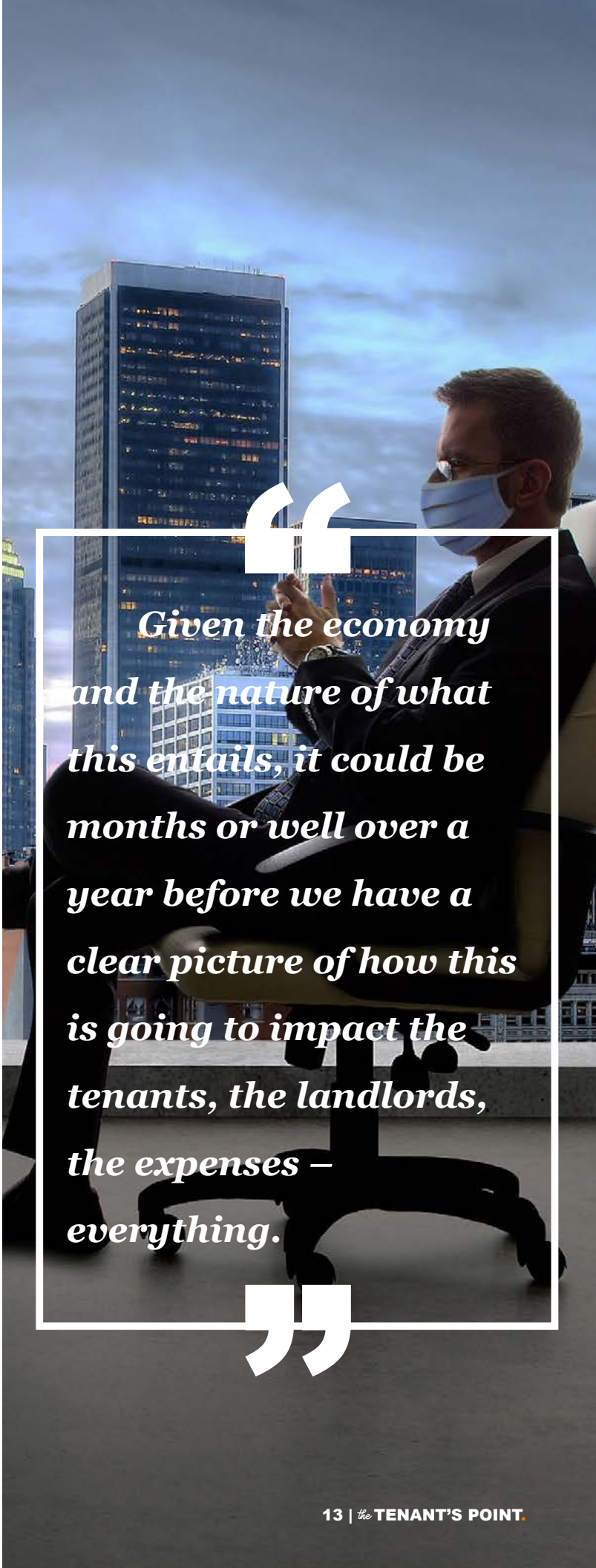
A few lease clauses we've been focusing on for our clients are: cleaning, maintenance, and looking ahead to 2021 when CAM statements come in, gross-up provisions. Tenants need to understand their and their landlord's obligations surrounding cleaning of both the common areas and the tenant's space and who pays for it. Are there additional costs for cleaning beyond the scope of standard cleaning specs? Does the tenant pay for that? As far as maintenance is concerned, who is responsible for what? Tenants will want to understand their maintenance obligations from both a performance and payment standpoint. They may not be consistently occupying their spaces for the next 12-18 months or so, but that doesn't absolve them from performing their

maintenance obligations, or any of their other lease obligations for that matter. Most leases have a gross-up provision, which impacts operating expenses that vary with occupancy, such as janitorial costs, utilities, and trash removal. In Q1 2021, when tenants start receiving their 2020 year-end statements, they should be sure to take a look at those variable costs in relation to their gross-up language.

What should tenants think about regarding lease language in the future?

Obviously, what's foremost on a tenant's mind right now is this: "If we sign a lease or an extension, is there any way to protect us from paying rent in the event of another pandemic?" It'll be interesting to see how that concept pans out. Will landlords be open to having that discussion and including language that provides tenants some level of rent relief should there be another outbreak? If yes, what does that rent relief look like? Will it be a deferral? A true abatement? How will terms such as "pandemic" or "business closure" be defined? Will landlords push back and tell tenants to look to their insurance providers for coverage if there's another outbreak? Will that result in another type of insurance coverage or will it be an option for business interruption insurance? It'll be very interesting to see where we end up.

Tenants always want to protect themselves and make sure they have a lease that's fair to both parties, but is also in-line with market standards and limits their financial exposure. As a tenant, you want to pay what's fair, but don't want to pay more than you have to. It's only been three to four months, so I think more changes are coming in the future. Given the economy and the nature of what this entails, it could be months or well over a year before we have a clear picture of how this is going to impact the tenants, the landlords, the expenses – everything.



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About McCall & Almy

McCall & Almy, Inc. is an independent, Boston-based commercial real estate advisory firm that provides a complete range of services locally, nationally and internationally. Focused on tenant representation and strategic real estate planning, McCall & Almy delivers comprehensive analysis and innovative real estate solutions that align with its clients' overall business strategies. McCall & Almy is proud of its long-standing relationships with corporate and entrepreneurial business entities as well as not-for-profit organizations. To learn more, visit www.mccallalmy.com or follow @McCallAlmy on Twitter.

For More Information

Kati Brigham
Vice President
+1 781.789.5288
kbrigham@mccallalmy.com

Jim Canfield
Executive Vice President
+1 617.827.7660
jcanfield@mccallalmy.com

Chris Chou
Vice President
+1 617.818.5099
cchou@mccallalmy.com

John Dolan
Senior Vice President
+1 617.947.1793
jdolan@mccallalmy.com

Lauren Donahue
Senior Vice President
+1 847.917.2664
ldonahue@mccallalmy.com

Jennifer Elia
Senior Vice President
+1 617.538.6551
jelia@mccallalmy.com

Rob Glor
Vice President
+1 617.548.5986
rglor@mccallalmy.com

Michael Goodwin
Vice President
+1 508.397.1095
mgoodwin@mccallalmy.com

Julie Gray
Executive Vice President
+1 617.678.1220
jgray@mccallalmy.com

Garrett Larivee
Executive Vice President
+1 617.838.9050
glarivee@mccallalmy.com

Bill McCall
President
+1 617.838.9393
wmccall@mccallalmy.com

Lenny Owens
Executive Vice President
+1 617.838.9191
lowens@mccallalmy.com

Dave Richardson
Executive Vice President
+1 617.838.9343
drichardson@mccallalmy.com

Neil Schneider
Executive Vice President
+1 617.306.9216
nschneider@mccallalmy.com

Sandy Tierney
Executive Vice President
+1 617.838.9474
stierney@mccallalmy.com