Cassels

A Tenant's Perspective - Re-evaluating Your Company's Real Estate Needs During the Pandemic

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The pandemic will have a significant long-term impact on the commercial leasing market as companies re-evaluate the ways they do business and their real estate needs. For example, many companies are considering doing away with, or reducing the size of, retail locations in favour of online operations, having employees work from home, or maintaining a physical location in urban centres but with inventory and storage facilities located in lower-cost suburbs.

This article sets out some of the key considerations in weighing a tenant's lease options going forward. Specifically, this article discusses lease renewals and extensions as well as subleasing space.

One factor to note is that the demand for a type of space affects the leverage between the landlord and tenant in lease negotiations. Generally speaking, industrial space has been the least-affected by the pandemic, as many industrial operations were deemed essential services by the government. The most immediate effects of the pandemic have been on retail space, particularly enclosed malls given mandatory closure orders, the increase in online shopping and the rash of retailer bankruptcies.

We anticipate that new office space will continue to become available, given the insolvency of some companies as well as others making strategic decisions to reduce the size of their space.[1]

LEASE RENEWALS AND EXTENSIONS

With a lease approaching the end of its term, some tenants may decide that remaining in their current space makes the most sense for their business and will exercise their option to renew or extend their lease. Key factors that tenants should take into consideration include (i) customer convenience, (ii) reputation in the area, (iii) access to transportation and supply chains, (iv) the market for the particular type of space and (v) availability of alternative spaces.

Focusing on factors (iv) and (v) above, tenants may be able to leverage the higher vacancy rates for commercial spaces, particularly as it relates to retail and office spaces, to renegotiate rents at lower rates than what is currently being paid under their lease. While most renewal and extension provisions generally provide that the base rent for a renewal or extension term cannot be lower than the base rent of the immediately preceding term, the uncertainty resulting from the pandemic has created a unique environment for negotiation.

Tenants should remain cognizant of the deadlines provided in their lease by which they must provide landlords with notice of their intent to exercise their options to renew or extend. Tenants should not wait until the last minute to engage landlords in renegotiations and to begin conducting their due diligence on alternative options. Instead, tenants should proactively communicate with their current landlords, and explore alternative options far in advance of any notice deadlines in order to put themselves in the best position to make the most prudent business decision in the context of leasing space.

While there may be room for renegotiating rent for retail and office spaces, the same likely cannot be said for industrial spaces. So far, industrial lease rates throughout Metro Vancouver remain largely unchanged from those negotiated in the first quarter of 2020 and there has been virtually no discounting or rate reductions at renewal for deals completed after the end of the first quarter of 2020.[2]

SUBLEASING SPACE

For tenants with multiple years left in their lease term who are occupying a footprint larger than they require, subletting excess space should be considered. Alternatively, tenants should consider negotiating an early termination of their lease and subletting space from another tenant. Patterns concerning the subletting of space already appear to be emerging as the amount of office space being subleased in downtown Vancouver is at twice the historical average.

From a subtenant's perspective there are many benefits with subleasing space, including shorter, and likely better, terms. From a sublandlord's perspective, there are potential networking opportunities if the subtenant operates a business that is complimentary with that of the tenant's as well as retaining an option to reclaim the subleased space once the long term affects of the pandemic on businesses patterns become known (i.e. keeping open the possibility of moving back into the subleased space once the sublease term expires and information is available regarding long term economic outlooks).

Along with the potential benefits, tenants will also need to turn their attention to potential costs associated with dividing the space, obtaining the landlord's consent (the terms of the lease should be reviewed), preparing sublease documentation and the business reality of being in the space for a shorter term. Depending on the amount of time remaining on the existing lease term, the costs associated with subletting the space may be modest compared to the costs that may be incurred by a tenant for retaining space that is not being used.

CONCLUSION

There is a significant amount of uncertainty surrounding what the post-COVID-19 world will look like. While there are many companies which have already determined that they will not require the physical space they currently occupy, and are thus thinking of exit strategies with respect to their leases, there are many other tenants who will be looking for short-term flexible solutions to assist with navigating these uncertain times.

Regardless of what side of the equation businesses fall on, it is always possible to find creative and practical solutions which benefit both tenants and landlords. Speak with one of our Firm's commercial leasing experts to understand what options are available to you.

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[1] For example, Vancouver's downtown office vacancy rate rose to 3.3% this quarter, up from 2.2% a quarter earlier and Toronto's downtown office vacancy rose to 2.7% in the second quarter, up from 2.0% in the first quarter. Additionally, rents for office spaces also fell in each city, with Vancouver seeing a drop of $1.62 for Class A office space and Toronto seeing a drop of $1.53 for such space (www.cbre.ca/en/about/media-center/cbres-second-quarter-statistics-show-covid-19s-impact-on-canadian-commercial-real-estate)

[2] Ibid.
