HOULIHAN LOKEY

REAL ESTATE:
Actions to Take Now and Later

Spotlight on COVID-19 | April 2020

Introduction

The worldwide disruption of businesses and supply chains through government-suggested or government-mandated social distancing and other measures has created a heightened uncertainty in economic forecasts, tightening credit markets and increased volatility in the global financial markets. These effects may lead companies that own, operate, or rent real estate to assess their portfolios, valuations, operations, and financing arrangements.

In this challenging environment, Houlihan Lokey stands ready to assist occupiers and landlords as they consider taking the following actions:

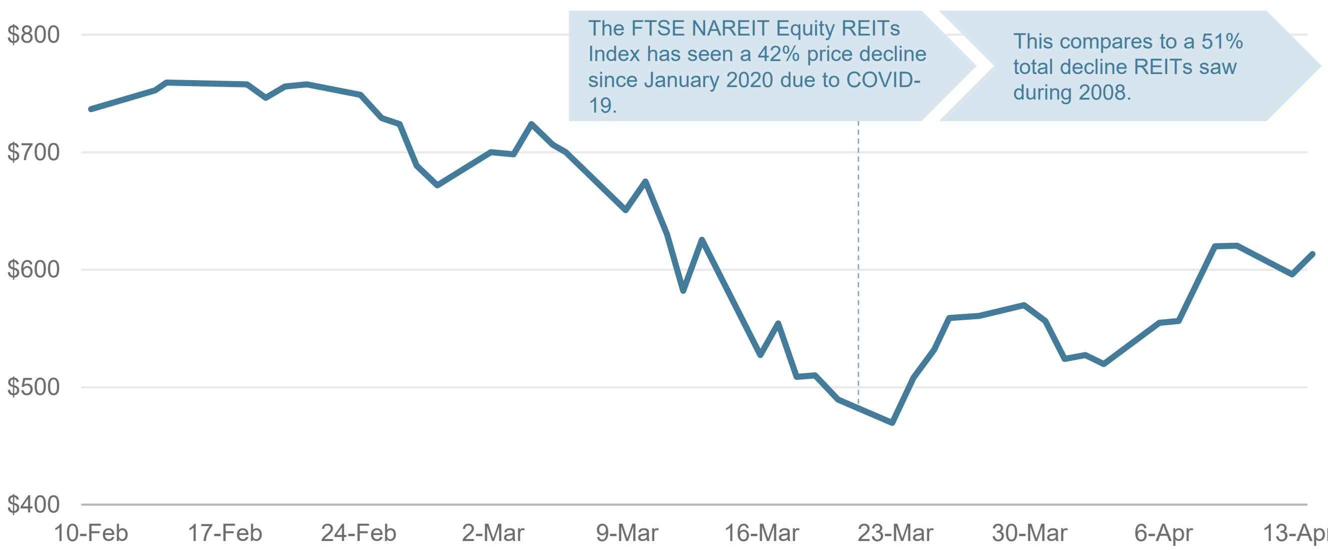
- Review lease and debt agreements for relevant clauses, covenants, and remedies
- Consider the effect of rent relief discussions and potential modifications to existing leases on valuation, accounting, and legal matters
- Review insurance policies and business continuity plans with your legal counsel
- Consider near-term liquidity needs and potential alternative sources for liquidity

This article will discuss the effects of the COVID-19 crisis on lessees and lessors as well as highlight key accounting, valuation, legal, and financial issues to consider.

HOW DO I MEASURE THE MAGNITUDE AND TIMING OF POTENTIAL VALUE DECLINES GIVEN CURRENT MARKET CONDITIONS?

The Last Economic Disruption

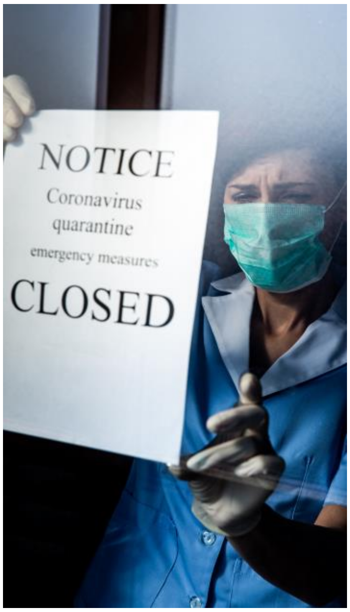
The retail sector is putting similar pressures on landlords to provide rent abatements and deferrals, as last observed during the Great Recession of 2008. At that time, weakened consumer buying led to store closures and a shrinking demand for retail space, and an overall decline in real estate prices occurred. Similar but more dramatically presented trends are occurring now. Instead of reduced foot-traffic levels, retailers and their respective landlords are contending with the elimination of foot traffic altogether.



Sources: MarketWatch and NAREIT

During the current COVID-19 crisis, we are seeing quarantines and lockdowns across the United States as well as unemployment claims hitting record highs. Coupled with voluntary or government-mandated store closures, this lack of mobility and loss of income has put enormous operational and liquidity pressure on many industries, with the effects being most severely felt within the retail, travel, and hospitality sectors. Given the unprecedented nature of the situation and uncertainty around how long the shutdown will continue, it is likely that the downturn will soon affect other sectors of the commercial real estate industry. Both landlords and tenants will need to be proactive and innovative in this rapidly changing climate.

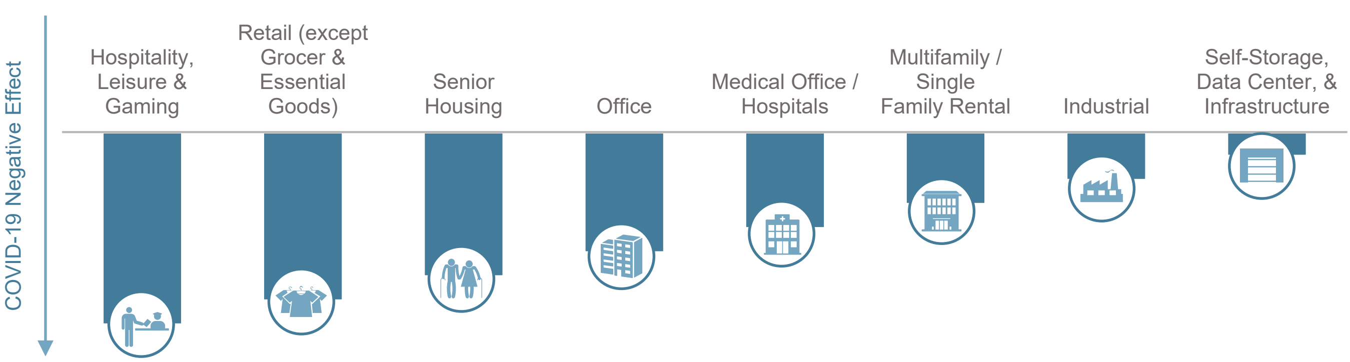
The Initial Wave



Over the past few weeks we have witnessed only the initial shock of the COVID-19 outbreak on the real estate industry. Not surprisingly, one of the early-hit sectors was retail, due to government-suggested (or government-mandated) closures of non-essential businesses, a reduction in travel, and various effects from social distancing measures. Many were quick to point out the effect to the restaurant industry; however, with major retailers closing storefronts and large mall owners closing nationwide portfolios, broader effects were felt shortly thereafter. These closures have led many retailers to push for rent reprieves during this time. While some landlords are proactively offering rent relief, such as Irvine Co. announcing a three-month rent delay for tenants in their retail centers in mid-March, a wave of negotiations with landlords is forthcoming.

Many outside the retail space are also affected by the crisis in one form or another: office landlords concerned about whether their tenants will be able to stay solvent in this crisis, landlords inundated with rent relief demands from tenants, and hotel owners and operators pursuing cost-containment strategies to mitigate the dramatic declines in occupancy. As noted in a recent publication by Cohen & Steers, the crisis may hit all real estate sectors.

SECTORS EXPECTED TO BE MOST AND LEAST NEGATIVELY AFFECTED



While it is unknown how long this crisis will last, its effect on the real estate industry will clearly be a substantial one, and there are many factors lessees and lessors will need to consider to survive this difficult period.

Immediate Effects

LESSEES

It may be most obvious to observe the effect on lessees, as they are immediately and directly affected by the loss of sales and the loss of access to their rented space. As a result, many retailers and other lessees are seeking rent relief from their landlords to help bridge a near-term liquidity crunch. Our discussions with tenants and landlords, and a review of publicly made statements by retailers around the globe, indicated that exact relief measures vary—some lessees are seeking one month of relief, while others are seeking up to 12 months (with most initially seeking one to three months of relief). Still others are seeking creative arrangements (e.g., a 50/50 split of rent during the crisis). No matter the length or type of rent relief being sought, there are accounting, legal, and liquidity effects to consider:

Valuation and Accounting

Potential Effects on a Lessee's Right-of-Use Asset and Lease Liability

Rent Concessions

Under ASC 842, changes to a lease contract that affect the contractual rental payments may result in (i) accounting for the change as a rent concession under the original lease agreement (i.e., a change in variable rent payments) or (ii) accounting for the change as a lease modification. These rent concessions can take many forms, such as rent reductions, rent deferrals, or rent abatements.

Determination of how to account for rent concessions generally requires the lessee to consider the terms of the original lease agreement, whether the lessee had an enforceable right to such rent concession, and if any other terms have been modified in connection with the rent concession. Due to the number of technical inquiries the FASB has been receiving recently and the unprecedented nature of COVID-19, the FASB recently provided interpretative guidance on the matter. The FASB noted that a company can make a policy election to either treat the concession as variable rent or a lease modification as long as the total cash flows from the concession are substantially the same or less than those in the contract before the concession. If accounted for as variable rent, no remeasurement of the right-of-use (ROU) asset or lease liability is required. However, if accounted for as a lease modification, the ROU asset and lease liability may need to be remeasured. Any other modifications to the lease made in connection with the rent concession should also be assessed.

Immediate Effects (cont.)

Impairment Considerations
ROU assets may be impaired if the asset groups to which they belong are impaired. Store closures (voluntary or involuntary) and broader economic effects, such as changes to market rent as a result of volatile demand and other factors, are examples of triggering events that may require a lessee to assess one or more of its asset groups for impairment under ASC 360.

Additionally, some lessees may determine that they can no longer make use of the asset and abandon all or a portion of the ROU asset. Committing to a plan to abandon will trigger the need to assess and recognize an impairment of the abandoned ROU asset in accordance with ASC 360.

Change in Incremental Borrowing Rate
A lessee's incremental borrowing rate, which is generally the rate used to determine the lease liability for accounting and financial reporting purposes, may be affected by the current environment. Changes in market interest rates, a lessee's cost of capital, or a lessee's credit rating may have effects on the incremental borrowing rate. Lessees should consider working with their valuation experts to assess if a change to the incremental borrowing rate is appropriate.

Those entities that plan to adopt ASC 842 in 2021 should keep in mind that the trends discussed in this study may affect current ASC 840 lease accounting; however, any specific effects are not within the scope of this article. Our Accounting and Financial Reporting team stands ready to discuss ASC 840 effects as needed.

Legal

Specific legal issues to consider in the current environment for lessees include, among others, (i) whether the lessee has an enforceable right to rent relief (discussed above), (ii) if closure of buildings by landlords in the current environment is the result of force majeure, and (iii) the effect of non-performance under a lease contract on future lease payments or other agreements in place that may have covenants related to a lease or store performance.

Immediate Effects (cont.)

LESSORS

Travel restrictions, building closures, potential loss of rent, and tightening of the capital markets have already negatively affected—and will continue to negatively affect—the commercial real estate industry. The amount and timing of the effect on landlords will likely vary by sector, but most landlords should be considering the following:

Valuation and Accounting

The effect on a lessor's financial statements may largely depend on their basis of accounting; however, valuation will certainly be a discussion for all owners. Regarding valuation, it is important to keep in mind that there is likely a mismatch between published transaction prices/rates and the current environment, as those deals closing today were likely negotiated 30 or more days earlier. Lessors should consult with their valuation advisors and be mindful that these historical indicators may not reflect current market conditions or assumptions.

Public companies and those that have adopted historical cost accounting should be considering the effects of potential impairment to their owned assets and collectability of lease payments from their tenants. ASC 360 requires a two-step evaluation that is first informed by the presence of a "triggering event." Step one of this standard considers the results of an undiscounted cash flows analysis, as expected by management. Step two is based on a fair value measurement (as defined under ASC 820) to estimate the amount of the impairment. If the COVID-19 crisis is prolonged and the negative economic effect continues, or if an owner now plans to dispose of an asset that is underperforming, landlords will most likely need to consider potential impairment charges under ASC 360.

For those reporting fair value financial statements, the effect of COVID-19 may come much sooner, as ASC 820 requires one to use market participant assumptions, which, in the current environment, may be significantly less optimistic than the assumptions observed in the prior reporting period. For example, the decline in retail sales may lead to decreases in future achievable rent, and tightening of the capital markets may lead to a smaller pool of buyers with a higher cost of capital, both of which would have a negative effect on real estate values.

Immediate Effects (cont.)

Legal

As noted above, there are specific legal issues to consider in the current environment. Based on tenants' increased demand for rent relief and a lack of clarity as to when the crisis may end, we expect increased discussions between tenants and landlords—and some of these may end up in legal or financial disputes. We would expect these disputes to primarily arise from clauses in certain leases or a lack of clarity as to a landlord's or tenant's rights in the current situation. Landlords are encouraged to review their lease agreements at this time to identify their rights and potential covenants related to a lease or store performance.

Liquidity

The situation for landlords is further complicated by their relationships with mortgage lenders and the need to make interest payments on debt. Most commercial mortgage agreements contain debt covenants requiring certain coverage ratios that are primarily affected by the landlord's ability to collect rental payments. It is expected that the loss of rent for 1–12 months will trigger a breach of these covenants. While certain sectors are preemptively trying to mitigate this effect—the International Council of Shopping Centers announced that they have asked the government to require all regulated mortgage lenders to offer a 90-day forbearance on all commercial loan obligations—currently, this overall effect is unknown. Therefore, during this crisis, landlords should be proactive in working with their lenders to reach an accord and avoid unnecessary breaches and potential foreclosures. Once these arrangements are solidified, landlords will be better positioned to potentially abate or restructure tenant lease agreements.

Time to Reassess

In the few short weeks since the onset of COVID-19, its effects have already raised important issues for tenants and landlords. Some of the concerns are as follows:

- Liquidity concerns (seeking near-term cash relief)
- Legal questions around renegotiating leases and forced closures
- Valuation, financial, accounting, and tax effects
- The effect on debt covenants and the commercial mortgage market

For players that have a plan in place to deal with such issues, the current environment may also be an opportunity for them to assess their portfolios to identify potential cost savings or revenue-enhancement opportunities going forward. For those that do not have a plan, it may be prudent to have discussions with third-party experts who can help navigate these waters.

Take Action

While it's difficult to see past the pessimistic tone in the media today surrounding the retail industry, hospitality industry, and overall real estate market, the current situation may provide an opportunity for certain lessees and lessors to exit the crisis in an advantageous position. Times of challenge lead companies to seek out cost-reduction measures but also provide an opportunity to strategically reassess one's footprint and where right-size opportunities are present.

Houlihan Lokey's group of real estate industry experts stand ready to assist lessees (occupiers) and landlords in navigating these turbulent times and can assist with any of the potential courses of action shown below.

In the immediate term, we suggest occupiers and landlords take the following actions:

- Review lease and debt agreements for relevant clauses, covenants, and remedies
- Consider the broader effect of rent relief discussions and potential modifications to existing leases—this may be a time to seek changes in rent structures, lease terms, etc.
- Review insurance policies and discuss potential remedies with your legal counsel
- Consider near-term liquidity needs and potential alternative sources for liquidity

Occupiers and landlords may consider taking the following actions over the next 3–12 months:

- Leverage industry experts and third parties in a strategic assessment of occupied or owned real estate against business objectives, considering if there are certain locations that could be shut down, disposed of, sold under a sale-leaseback, etc.
- Work with disputes and property tax appeal experts to identify assets for potential tax appeal given the change in market conditions and certain properties' operating performance (e.g., lower occupancy, reduced rents), as there may be an opportunity for owners to reduce their property tax burden (now or come the next lien date)
- Engage your accounting and valuation specialists now to start understanding the effect on your financial statements
- Work with real estate specialists to reassess rent reimbursement calculations and methods, as there may be effects to consider as a result of voluntary property closures, a lack of availability of common areas and services provided for in a lease, a tenant voluntarily closing its store, or government-mandated closures
- Have a discussion with tax professionals to consider provisions in the Coronavirus Aid, Relief, and Economic Security (CARES) Act that may be beneficial to your business

Take Action

Houlihan Lokey has a successful track record in assisting its real estate occupiers and owners through times of extreme volatility and exogenous events.

Please reach out to one of the team members below for more information.

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