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Operating Expense Pass-Throughs and COVID-19 Guide

The impact of COVID-19 on operating expense pass-throughs in Canadian commercial real estate.

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Executive summary

In late 2019, when we first heard about a *novel coronavirus* that had been identified in Wuhan, China, none of us could have imagined the global impact this microscopic invader would have in 2020 – and beyond. What was eventually named Severe Acute Respiratory Syndrome coronavirus 2 (SARS-CoV-2) – more commonly known as COVID-19 – not only created a global pandemic, but it also precipitated the worst financial meltdown since the Great Depression more than 90 years ago.

The pandemic–induced recession is unlike any other previous economic downturn, and it is unique in its global reaction and reach. Entire countries, regions, and cities have instituted shelter in place orders or were locked down. And, as of December 2020, a second wave of COVID-19 infections has exploded in regions around the world. COVID-19 has forced an abrupt change in the way we work and has precipitated a massive shift to remote working and significant (and lasting) lifestyle changes. These converging factors will have significant and long-term implications for the commercial real estate (CRE) industry.

For many CRE investors, COVID-19 is expected to have a significant impact on operating expense pass-throughs for 2020 – and perhaps several more years into the future:

Certain property-related expenses are likely to increase, including:

- COVID-related deep cleaning and disinfecting costs
- Additional janitorial service as buildings reopen (high touch point cleaning)
- COVID-related re-occupancy costs (signage, partitions, hand sanitizer, etc.)
- COVID-related compliance costs (new protocols, testing, equipment, staffing, etc.)

Certain other expenses are likely to decrease because of the period of reduced occupancy, including:

- Trash removal
- Overall janitorial expenses
- Utilities

Some operating expenses are likely to remain the same, including:

- Service contracts
- Proactive maintenance
- Landscaping (although some property managers might have deferred certain landscaping costs – like flower rotations – because of reduced occupancy)
- Real estate taxes

Not all properties will be impacted by COVID-19 in the same way. For some properties, the coronavirus pandemic will precipitate large swings in income, operating expenses, and capital expenses. In other properties, the impact will be minimal – if at all.

The global pandemic came on quicker and more profoundly than anyone could have predicted, and it will take quite some time to return to "normal" again. Economists' predictions differ on when we will recover from the Recession of 2020. Some say the recovery will occur in 2021, and others suggest it will take years to recover from such a deep recession.

"We are all in this together" has become a popular catchphrase in the COVID-19 era – one that will indeed be tested as tenants and landlords sit down at the virtual negotiating table. The pain is being felt at all levels – from the consumer up to the lender. Will this result in mutually beneficial lease and loan workouts? In this continually evolving environment, only time will tell.

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BOMA Canada sincerely regrets any errors or omissions.

COVID-19

At the start of 2019, the commercial real estate (CRE) industry was in a stable position. Balance sheets were strong, there was plenty of capital available, and leasing and sales in most markets were healthy. By most accounts, C-Suite executives in CRE companies expected 2020 to be a banner year.

Along Came COVID-19

In late 2019, when we first heard about a *novel coronavirus* that had been identified in Wuhan, China, none of us could have imagined the global impact this microscopic invader would have in 2020 – and beyond. What was eventually named Severe Acute Respiratory Syndrome coronavirus 2 (SARS-CoV-2) – more commonly known as COVID-19 – not only created a global pandemic, but it also precipitated the worst financial meltdown since the Great Depression more than 90 years ago.

The term "unprecedented" is often overused. However, in the case of the COVID-19 pandemic, "unprecedented" is an effective descriptor of the intensity by which this coronavirus has permeated our lives.

While the medical, psychological, and financial impact of the COVID-19 pandemic continues to unfold globally, the rapid pace at which the pandemic is spreading – and the global actions that have been put in place to curtail it – are resulting in unprecedented changes to our lives and livelihoods.

The pandemic–induced recession is unlike any other previous economic downturn, and it is unique in its global reaction and reach. Entire countries, regions, and cities have instituted shelter in place orders or were locked down. And, as of December 2020, a second wave of COVID-19 infections has exploded in regions around the world. COVID-19 has forced an abrupt change in the way we work and has precipitated a massive shift to remote working and significant (and lasting) lifestyle changes. These converging factors will have significant (and lasting) implications for CRE.

For several reasons, the commercial real estate industry historically lags about six months behind the broader economy when entering a recession – and then again when starting to recover from one. However, the expansive depth and the unprecedented reach of the global COVID-19 pandemic has impacted the commercial real estate industry much sooner – and much more severely. Recovery is expected to take much longer.

Government programs (at all levels) have proven effective in stabilizing the economy and preventing an unprecedented economic meltdown. In particular, the **Canada Emergency Commercial Rent Assistance (CECRA)** program for small businesses lowers rent by 75% for small businesses that have been affected by COVID-19[1].

> *CECRA (provided) forgivable loans to qualifying commercial property owners, whether they have a mortgage on their property or not. The loans cover 50% of monthly rent payments that are payable by eligible small business tenants who are experiencing financial hardship during April, May, June, July, August, and September. The loan covers 50% of rent, the landlord waives 25%, and the tenant pays the remaining 25%.*

> *The loans will be forgiven if the qualifying property owner agrees to reduce their small business tenants' rent by at least 75% under a rent reduction agreement, which will include a term not to evict the tenant while the agreement is in place. The small business tenant would agree to cover the remainder, up to 25% of the rent.*

The CERCA program was replaced by the Canada Emergency Rent Subsidy (CERS)[2].

> *CERS helps businesses, charities, and non-profits that have suffered a revenue drop due to COVID-19. It subsidizes a percentage of expenses,*

1 Small Business BC - Canada Emergency Commercial Rent Assistance (CECRA)

2 Small Business BC - Canada Emergency Rent Subsidy (CERS)

PUTTING IT INTO PERSPECTIVE

According to Statistics Canada:

- Real gross domestic product contracted at an annualized rate of 38.7 per cent for the quarter, the worst posting for the economy dating back to when comparable data was first recorded in 1961.
- Unemployment soared to 13.7% in May 2020 - with more than 8.9M applying for Canada Emergency Response Benefit (CERB).
- Most economists fear a "double dip" recession – meaning there could be another downturn until the country recovers.

> *on a sliding scale, up to a maximum of 65% of eligible expenses until June 2021. Hard-hit businesses subject to a lockdown could receive rent support of up to 90%.*

In addition, many landlords have attempted to help struggling businesses by offering them rent relief and other concessions.

However, as the government deferrals expire, more support will likely be needed in 2021 for tenants that have not yet fully recovered.

The impact of these government programs and landlord concessions was significant. According to a recently published infographic from Colliers International, The Impact of Commercial Rent Relief[3], many tenants that were on the verge of shutting down were kept in business with the help of the financial support they received from the government and their landlords.

3 Colliers - The Impact of Commercial Rent Relief

COVID-19 and business plans

In a typical year, creating accurate business plans and reforecasts can be challenging. However, once again, the term "unprecedented" is applicable here. Property managers have never had to create business plans and reforecasts in the face of such unprecedented uncertainty. No one knows what the rest of 2020 will look like – much less what will happen in 2021.

As they navigate the COVID-19 pandemic, property managers must take into consideration:

- Drastic reductions in occupancy at some properties – which will drive reduced costs for many variable operating expenses
- At retail properties where tenants pay rent based on a percentage of gross sales ("percentage rent"), the results could go either way
  - For tenants that have been forced to curtail their business, gross sales are likely much lower than usual – which will translate into dramatic reductions in their rent payments.
  - Some tenants have seen their businesses skyrocket during the pandemic. To the extent they are required to pay rent based on gross sales, the landlord will receive higher than anticipated rent payments.
- Deferred rent payments
  - The manager will also have to make assumptions about when (if ever) those deferred rent obligations will be repaid.
- The potential for tenants to go out of business before the economy improves
- Dramatic swings – both up and down – in specific expense categories
- Systems-related cost changes – as examples:
  - Utility costs from running HVAC equipment for an extended period and water/sewer costs from flushing the potable water system
  - HVAC costs from purchasing higher-quality air filters and from increased air filter replacement frequency

It has been a challenge to create accurate reforecast budgets for 2020. And, given the unprecedented levels of economic uncertainty we are currently experiencing, accurately preparing 2021 business plans proved to also be a challenge.

COVID-19 and operating expenses

COVID-19 is expected to have a significant impact on operating expense pass-throughs for 2020 – and perhaps several more years into the future:

Certain property-related expenses are likely to increase, including:

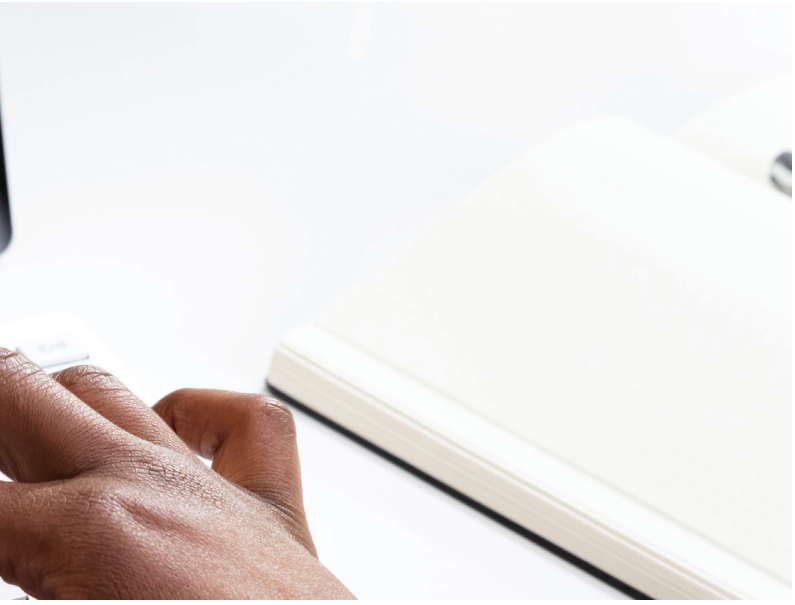
- COVID-related deep cleaning and disinfecting costs
- Additional janitorial service as buildings reopen (high touch point cleaning)
- COVID-related re-occupancy costs (signage, partitions, hand sanitizer, communication to tenants to prepare to return to work, etc.)
- COVID-related compliance costs (new protocols, testing, equipment, staffing, etc.)

Certain other expenses are likely to decrease because of the period of reduced occupancy:

- Trash removal
- Overall janitorial expenses

Some operating expenses are likely to remain the same:

- Service contracts



- Proactive maintenance
- Landscaping (although some property managers might have deferred certain landscaping costs – like flower rotations – because no tenants were in the building to appreciate them)
- Real estate taxes

It is also likely that certain non-operating expenses will increase as well. As an example, many property managers will incur higher than usual legal fees to review lease language, revise property rules and regulations, provide counsel to the landlord for COVID-19-related issues, and respond to tenant concerns. While these increased expenses will not impact operating expense pass-throughs, legal fees will be a significant – and unanticipated – burden in 2020 (and perhaps beyond). Aside from lease legal fees, in some cases, landlords will also have to incur non-operating costs to prepare newly vacated spaces for leasing, increase marketing to attract new tenants, and maintain those vacancies until they can be re-tenanted in the future.

In most cases, landlords maintained building systems and kept their buildings fully operational during the pandemic – regardless of actual tenant occupancy levels. Some tenants might not fully understand the landlord's obligations to keep the buildings operating smoothly – or the associated cost to do so. It is a good idea to keep the tenants aware of the landlord's work to keep the building "open for business" – even if the tenant did not physically occupy the space.

Despite the unprecedented impact of the coronavirus on CRE, some landlords might be contractually obligated to spend money in certain areas. For example, many retail landlords are required to provide certain advertising and marketing campaigns for the benefit of the tenants in their centers. Given the long lead time to produce and schedule these campaigns, many landlords were forced to continue their marketing programs even though the buildings were – at least for a short time – shuttered.

As noted previously, the impact of COVID-19 on operating expenses will vary from building to building. As examples:

Utilities

- Typically, utility costs are in direct proportion to building occupancy. With fewer people in the building, electricity use (for HVAC, lighting, plug loads, etc.) is likely to be down from a typical year. And water/sewer charges might also be lower in 2020
- However, the landlord might have implemented certain best practices to reduce the chance of COVID-19 transmission in the building, including:
  - HVAC units were operated for more hours (although likely at lower loads) during the pandemic:
    - Building ventilation rates were raised above ASHRAE minimums to increase the amount of outside air brought into the building.
    - Many owners performed building "flushes" by opening the outside air dampers and running the HVAC equipment around the clock to maintain indoor air quality.
  - Due to the potential that standing water in the potable water system would support biofilm growth, many landlords routinely flushed the potable water system. Doing so would incur a cost for the water that was used for flushing and refilling the system.

Property Management Fees

- If the tenants continue to pay rent, the property management fees will not change.
- At many properties, in the face of significant rent abatements, property management fees will be much lower in 2020.
- If tenants resolve those rent abatements in 2021, the property management fees will be artificially high next year.

Management and Maintenance Staffing Costs

- Were all management and maintenance staff members retained during the period of reduced occupancy? If not, those expenses will be artificially low in 2020.

Property Insurance

- What will happen to property insurance premiums as claims are processed for pandemic-related losses incurred in 2020?
- Will landlords increase their insurance coverage to include pandemic-related losses and other provisions (like force majeure)? What impact will this have on insurance premiums?
- Based on losses incurred in 2020, will insurance premiums increase at renewal?

Security Guards

- If the property has existing security guards, were there any reductions in staffing resulting from the reduced occupancy?
- Did the property manager add additional services because building occupancy was low?

General and Administrative

- As property management companies pivoted to employees working remotely, did the property incur any costs associated with this change? (As an example, did the property purchase computer equipment for employees to use at home? Is this equipment being passed through as an operating expense?)

It is Fair – But is it Permitted Under the Lease?

It seems logical that, for buildings where COVID-19 impacts the operating expenses, landlords **should** gross-up the operating expenses to approximate a typical year.

For many properties, the operating expenses will be significantly lower in 2020 for the reasons noted above. However, Canadian real estate practices generally provide for a fair and equitable allocation of operating expenses. Key points include:

- Tenants are expected to pay to the landlord a proportionate share of operating costs.
- The term, "occupancy," is broadly defined to include spaces that are "completed, leased and occupied for any time period,"
- Operating costs are calculated based on the costs and amounts that would have been incurred or otherwise included in operating costs if the property was 100% completed, leased, and occupied – as determined by the landlord, acting reasonably.
- In most cases, the landlord is only permitted to adjust those expense categories that vary based on occupancy.
- In addition, lease provisions commonly preclude the landlord from recovering more than the landlord would collect if the property were 100% completed, leased, and occupied.

Read the Lease

Once again using the term "unprecedented," few leases contain language about how to address operating expense calculations in the middle of a global pandemic and the resultant massive economic collapse. As a result, landlords and tenants must rely upon the specific language of their leases to determine how to approach this dilemma.

As building owners evaluate their options, they should consider:

What does the lease say?

- Does the lease allow for the landlord to gross-up operating expenses?
- Do any specific pandemic-related conditions apply?
- Is the lease silent about gross-ups?
- What is the definition of "occupancy?" In many leases, a space is "occupied" if a tenant leases the space. Thus, by interpreting the lease language, the gross-up provision will not "technically" apply if the tenant's employees did not occupy the "leased" space. This potential concern is addressed in more detail a little later in the white paper.

What is fair?

- Regardless of what the lease says, what is the fairest way of calculating operating expense pass-throughs?

What can the landlords and tenants tolerate?

- The pandemic has not impacted all business sectors equally – and not all businesses in the sector are affected in the same way.
  - For example, many restaurants were closed entirely during the early phases of the pandemic – and then were open only on a limited basis as the social distancing requirements were relaxed
  - Consumer confidence is one of the main drivers of retail consumer spending. Lockdowns have significantly impacted consumer confidence, having reached an all-time low during the worst of the pandemic, According to Colliers International in their report, Retail Recovery: Sales, Traffic, and Changes to Retail Space[4], this decline is regional, and not national. As a result, expect brick and mortar retail to perform much better in provinces with loosened restrictions.
  - Led by significant growth in e-commerce, industrial properties are faring well. According to Colliers' Q4 industrial report[5], a pandemic-induced reliance

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4 Colliers - Retail Recovery: Sales, Traffic, and Changes to Retail Space

5 Colliers - Industrial Recovery: Inventory, Demand, and Space Needs

6 Colliers - Office Recovery: Space Needs and Productivity

on e-commerce increased this sector to a record 10.3% of total retail sales. This trend continues to drive demand for warehouse and distribution space. Tenants serving the supply chain of e-commerce were the least affected by COVID-19 from a demand perspective, according to the same report

- Office tenants that were able to pivot to a remote working model are doing well – but are increasingly asking whether their employees can permanently work remotely. In the long-term, they might not need to lease as much space.
- Interestingly, the ability for office employees to work from home varied by tenant size – with productivity being the most effective factor. According to Colliers' Q4 office recovery report[6], small businesses suffered the most decline in productivity – and, as a result, small businesses are about 50% less likely to reduce the size of their rentable space.

- Tenant size might also impact the tenant's tolerance level. As an example, if you have a shopping center full of "mom and pop" tenants that are struggling to stay afloat, you will need a very different strategy than you would for a shopping center full of national tenants.
- The key is to evaluate your specific property to determine the short-term and long-term impact on your property if tenants fail?
- According to Colliers, about 9% of retail tenants could go out of business[7] as a directly result of COVID-19. Approximately 6% of industrial tenants and 3% of office tenants are predicted to fail. The business failures are expected to skew towards small business and disproportionately impact certain industries (like restaurants).

What is common practice in your area?

- When discussing grossing up operating expenses in the era of COVID-19, some property managers identified that gross-up calculations in their area typically only include utilities, janitorial costs, and property management fees.
- In previous years, this might have been acceptable and reasonably accurate. However, since nothing about 2020 is typical, look carefully at your operating expense pass-throughs for this year. Just because you only grossed-up utilities, janitorial costs, and property management fees in the past, does not mean you are limited to only grossing up those amounts in 2020.

For most landlords, the solution will be combining these options: follow the lease, evaluate what is fair, consider what the landlord and tenants can tolerate, and think about standard practices in your area. The goal is to come up with a solution that takes into consideration the various interests of those who have "skin in the game," including:

The lender • The owner • The tenant

Unfortunately, regardless of whether landlords choose to follow the existing lease language or step outside the lease language to propose a different solution, there will undoubtedly be disagreements between landlords and tenants about handling operating expense pass-throughs during the pandemic. Not surprisingly, many of these disagreements are likely to end up in litigation.

Who Pays for COVID-Related Cleaning?

Tenants are accustomed to paying for their pro-rata share of the janitorial expenses associated with the building. It would seem appropriate to pass through any additional costs for COVID-related cleaning and disinfecting – especially those costs attributable to the entire building. However:

- What if the landlord performed additional cleaning and disinfection services in a tenant space due to a tenant's employee testing positive for COVID-19?
- What if the landlord performed extra cleaning and disinfection services in the common areas that this tenant's employee accessed?

Should these costs be considered tenant-specific costs – and then be billed to the individual tenant? That might be the fairest way to handle those costs.

Should deep cleaning and disinfection services in the common area be billed to all tenants as part of the operating expense pass-through? The property manager needs to think about segregating COVID-related costs between those that benefit the full building and those incurred for individual tenants.

7 Colliers - Office Recovery: Space Needs and Productivity

E-COMMERCE AND COVID-19

- Don't forget to account for the potential increase in on-line sales for retail tenants.
- How does the lease address e-commerce sales generated from bricks and mortar stores/ restaurants?
- Many retailers are not setup properly to report on these sales.
- What about online sales that are returned to bricks and mortar stores?
- It's probably time to re-define your lease language about gross sales. For example:

> *"Gross Revenue" means the sum of the sales prices of all sales of goods and services from all business conducted on or originating at the Premises, whether such sales are made or services performed at the Premises or elsewhere and shall include, for clarity, all internet or other e-commerce sales completed by delivery at or from the Premises or ordered or made through an internet or other ecommerce computer, terminal, or device located in the Premises.*

Action items

To mitigate the impact of COVID-19 on operating expense pass-throughs, property managers should:

- Review each lease, evaluate the existing lease provisions, and identify areas that are likely to become problematic in the future. Consider abstracting the applicable sections of the leases so that information is at your fingertips as you calculate operating expenses.
- Review the general ledger and identify COVID-related expenses. Separate expenses attributable to the full building from expenditures that are tenant specific. Consider creating subaccounts for COVID-related costs. (Maybe add a prefix of "COV" for COVID-related expenses applicable to the entire building and "COV-T" for COVID-related expenses that are tenant-specific. So you can use these expense line items beyond the era of COVID-19, you might want instead to add a generic, non-COVID prefix – like EE for "extraordinary expense." That way, "EE" would define any extraordinary expenses attributable to the entire building, and "EE-T" would identify tenant-specific expenses that are extraordinary.)
- Consider billing tenants separately – outside of the operating expense cycle – for tenant-specific expenses associated with COVID-19. Not only does this allow the landlord to recoup the COVID-19-related costs sooner, but doing so will enable each tenant to understand how the COVID-related expenses are going to be passed through. This will also simplify your operating expense reconciliations for 2020.
- Prepare 2020 operating expense estimates as soon as possible so you can identify potential issues and create solutions before it is time to bill tenants in the first quarter of 2021.
- Communicate your plan to tenants. Tell them how you plan to pass through operating expenses related to COVID-19. Let them know that you recognize the challenges of calculating operating expenses for this year and are working on a plan that treats both the landlord and the tenant fairly.
- If you have given rent concessions in 2020, consider how you will calculate your management fee (and other expenses based on property income) for 2020 and 2021. This might have an impact on 2020 and 2021 operating expense calculations (and base years). You should gross-up property management fees for 2020 (because they are lower than usual) – but what about 2021?
- Consider proactively negotiating a fair solution sooner rather than later – and put that solution in writing (in the form of a side letter or, preferably, a lease amendment).

Not All Tenants Are Equal

Ideally, any adjustments to your 2020 operating expense pass-throughs will be made at the property level – and will impact all tenants similarly. However, there might be situations where you might want to adjust the operating expenses at the tenant level. You might choose to negotiate differently with:

- Larger tenants v. smaller tenants
- Tenants nearing the end of their leases v. tenants with new leases
- Tenants that are struggling financially v. tenants where business is booming

As a best practice, you might consider:

- Calculating the operating expenses pass-throughs without any adjustments (as if 2020 was a "normal" year)
- Strategically evaluate property-level adjustments that impact all tenants
- Once you have made the property-level adjustments, evaluate options to make any adjustments at the tenant level
- Schedule one-on-one meetings with representatives of your tenants so you can review your planned adjustments to the operating expense pass-throughs

Thankfully, this "what if" analysis is made easier by budgeting software and spreadsheets. You should easily be able to assess the impact of a change by making the change in your operating expense calculation formula and reviewing the results.

The Long Game

Although the impact of the global pandemic came on quicker and more profoundly than anyone could have predicted, it will take quite some time to return to "normal" again. Economists' predictions differ on when we will recover from the Recession of 2020. Some say the recovery will occur in 2021, and others suggest it will take a few years to recover from such a deep recession.

With this in mind, focus on the "long game."

- Some tenants have already gone out of business or declared bankruptcy.
- Many government programs that are propping up the economy will eventually expire.
  - Experts predict the expiration of these programs will cause further economic deterioration – more failing businesses, higher unemployment, reduced consumer confidence and consumer spending, and higher vacancy rates for CRE.
- Many of the remaining tenants are struggling to survive.
- Thinking even longer-term – how will your decisions in 2020 (and 2021) impact tax appeals and property valuations? Much of the discussion so far has focused on property-level decisions. However, these decisions about COVID-19-related operating expenses changes need to be made with portfolio-level implications in mind – include the potential changes to:
  - Asset value
  - Existing loans – and the potential to refinance property debt
  - Property tax appeals
  - Insurance coverage
- COVID-19 prompted many tenants to evaluate their long-term planning, and many have elected to restructure their organizations to "buffer" themselves from future events. Are these short-term decisions that will be forgotten in a few years – or are these megatrends that will forever change the commercial real estate landscape? Who knows, but the next few years will be interesting as we see how all of this will play out.
- Expect significant changes to lease language in future negotiations – particularly as they relate to topics like force majeure, insurance, business interruption, default provisions, and standards of landlord and tenant performance under the lease.

Consider that just because you **can** pass something through to tenants does not mean you **should** pass it through. Until COVID-19 is behind us, the best strategy might be for landlords to sacrifice in the short term to position the property better for the long-term.

"We are in this together" has become a popular catchphrase in the COVID-19 era – one that will indeed be tested as tenants and landlords sit down at the virtual negotiating table. The pain is being felt at all levels – from the consumer up to the lender. Will this result in mutually beneficial lease and loan workouts? In this continually evolving environment, only time will tell.

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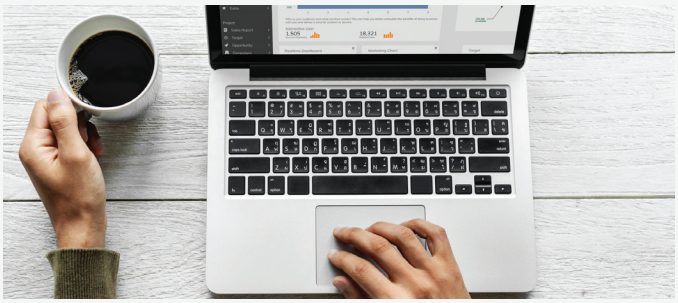

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