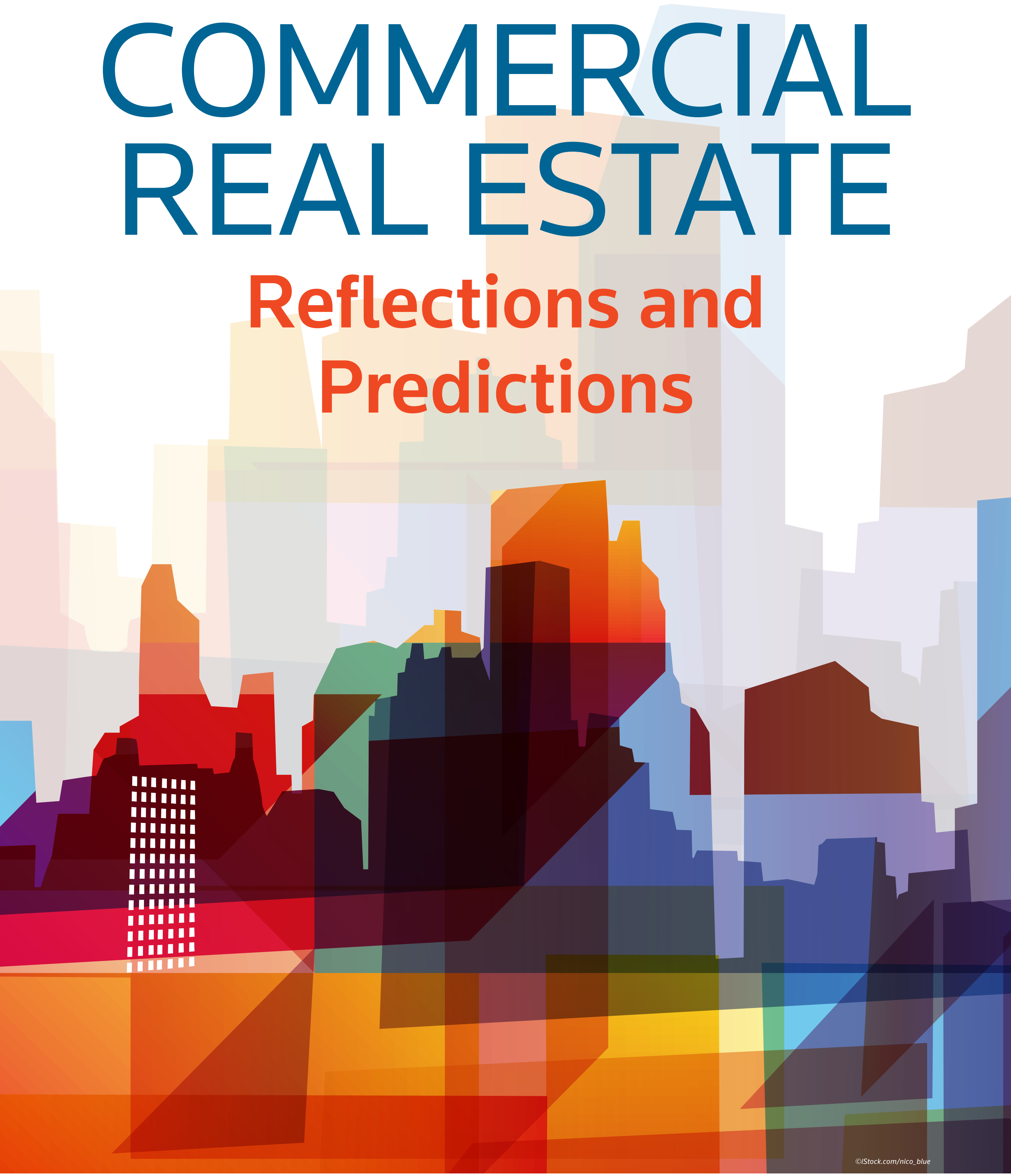
COMMERCIAL REAL ESTATE

Reflections and Predictions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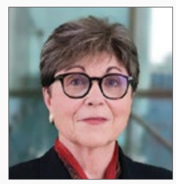
Practical Law Real Estate asked leading real estate practitioners to share their thoughts on recent trends and developments impacting the commercial real estate market, including the COVID-19 pandemic, and provide predictions for the rest of the year ahead.

JENNIFER CHAVEZ
PARTNER
SHEPPARD, MULLIN, RICHTER & HAMPTON LLP

Jennifer is a partner in the firm's San Diego office, specializing in land use and general real estate transactional matters. She represents developers, landowners, and public agencies in a variety of projects, including large- and small-scale residential, commercial, industrial, mixed-use, and educational development projects throughout California.

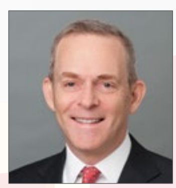


CLARAMARGARET H. GROOVER
OF COUNSEL
BECKER & POLIAKOFF, P.C.

Claramargaret is of counsel in the firm's Orlando office, and board certified in construction law. She focuses her practice on complex project development, negotiating and documenting performance requirements on condominium, mixed-use, and leaseback transactions, as well as public-private partnership projects, and coordinating construction and financing requirements.

BRADLEY A. KAUFMAN
PARTNER
PRYOR CASHMAN LLP

Brad is a partner in the firm's Real Estate Group and co-chair of the Leasing Practice. He has significant experience in leasing, acquisitions, and financing. Brad represents owners and tenants of office and retail properties in deals in New York City and throughout the US. His clients include global luxury brands, international retailers, restaurants, health clubs, and developers.



ANDREW A. LANCE
PARTNER
GIBSON, DUNN & CRUTCHER LLP

Andrew is co-partner in charge of the firm's New York office and head of the Real Estate Practice Group's Hotel and Hospitality Practice. His clients include private real estate equity funds, hedge funds, sovereign wealth funds, corporate and individual developers and owners, mortgage and mezzanine lenders, REITs, and other public and privately held companies investing in or using real estate.

STUART M. SAFT
PARTNER
HOLLAND & KNIGHT LLP

Stuart is the practice group leader of the firm's New York Real Estate Practice Group, co-chair of the Condominium Development and Conversion Team, and former co-chair of the Hospitality, Resort, and Timeshare Group. He has extensive experience in the development, financing, leasing, conversion-to-condominium and cooperative ownership, exchange, syndication, sale leaseback, timeshare, restructuring, acquisition, and sale of residential, commercial, and hospitality property.

KATHLEEN J. WU
PARTNER
HUNTON ANDREWS KURTH LLP

Kathleen is a partner in the firm's Dallas office. Her clients include private and public companies, hotel chains, governmental authorities, investment banks, syndicators, real estate developers, lenders, and loan servicers involved in the construction, sale, financing, servicing, leasing, and management of real property and related assets.

Despite ongoing uncertainty in the US about the COVID-19 pandemic and its effect on most aspects of society, commercial real estate experienced impressive growth in 2021, with almost all sectors rebounding to pre-pandemic levels. The strong market was fueled, in part, by inexpensive debt, a focus on industrial assets, and robust e-commerce activity.

Looking ahead to the remainder of 2022, experts predict that deal volume could exceed anything seen since the Great Recession ended in mid-2009. Signs pointing to continued market strength in the coming months include:

- Rents surpassing pre-pandemic levels in most parts of the US, which could lead to a record 2022 for the multifamily sector.
- A return of the hotel sector and hospitality transactions.
- An increase in capital markets activity, with a higher total investment volume in commercial real estate fueled by inexpensive debt.
- Greater demand for office space as more employers implement return-to-office plans.
- Continued growth of the industrial sector as e-commerce needs expand (for more information, search Industrial and Warehouse Leasing Toolkit (National and Select States) on Practical Law).

Against this background, Practical Law Real Estate asked leading real estate practitioners to share their views on the state of the US real estate market, including:

- Surprising developments.
- Trends in deal flow.
- Residual effects of the COVID-19 pandemic.
- Legislative impacts.
- Supply chain issues and labor shortages.
- Activity in secondary and tertiary markets.
- Hot topics to monitor in 2022.

SURPRISING DEVELOPMENTS

What developments in the real estate and construction markets surprised you the most in 2021? What will the real estate market look like in 2022?

Stuart Saft

I was expecting that 2021 would be a repeat of 2020, except that the pandemic would end and normalcy would return by the summer. I was wrong on both counts. The pandemic never ended, and we had to deal with the Delta and Omicron variants. Despite these challenges, 2021 was the busiest year in the real estate market I have ever experienced.

We were retained on a large number of new developments, as well as buildings that were being built as rentals but were turned into condominiums when the developers decided to pursue acquisitions and sales. I was expecting that many projects would encounter financial difficulties, and we would be doing workouts and bankruptcies. Instead, projects that had been on hold because of the softening real estate market were suddenly reactivated, and there were few workouts and no bankruptcies. Also, purchases of the unsold units in our condominium projects surged. This high level of activity continued throughout the year. We also started to work on multiple deals for or with nonprofits both acquiring and leasing space. And we worked nonstop on financings, including new C-PACE (Commercial Property Assessed Clean Energy) transactions.

Search NYC Adopts C-PACE Financing Rules for New Construction and Ground Leases for information on New York City's C-PACE financing program.

Jennifer Chavez

I was surprised by the number of deals and construction projects proceeding in 2021. We were busy at the end of 2020 and expected that to continue through 2021, but the volume was more than I anticipated. I think the market will continue to be busy through 2022, particularly for housing, logistics, and biotech projects.

Kathleen Wu

The fact that the market boomed, despite supply chain issues, labor shortages, and the lingering pandemic stops and starts, is what was most surprising about 2021. I am cautiously optimistic about continued market strength in 2022, but this optimism is tempered by the World Bank's recent prediction of a global economic slowdown in 2022 and 2023 brought on, in part, by the Omicron variant and continued supply chain issues.

Andrew Lance

The strength of the industry, reflected in the volume of transactions, including new development, was a surprise in 2021. The increase in interest rates in 2022 may have a moderating impact on the vitality from 2021, but so far we have not seen that as demand remains strong across all asset categories and even office leasing is picking up.

Claramargaret Groover

The biggest surprise was how hot the market was in certain areas of the country, such as Florida, and that it stayed hot through the COVID-19 pandemic despite inflationary and supply chain pressures on developers, contractors, and subcontractors. Construction trade industry economists, including the chief economist of the Associated Builders and Contractors, estimated that inflationary pressures may lessen in the second half of 2022, but this estimate predates the invasion of Ukraine. Owners and developers will be glad that cost escalation provisions and guaranteed maximum price (GMP) contracts allow flexibility to reduce construction costs, because inflation and supply chain cost increases will be less justified going forward.

Search Guaranteed Maximum Price Contracts: Drafting Strategies for information on the key cost considerations when drafting a construction contract with a GMP structure.

Brad Kaufman

What surprised me the most in 2021 was the slow pace of the marketplace to start and re-establish itself. The Omicron wave of the COVID-19 pandemic was extremely detrimental for businesses, particularly those in the retail sector. Any comeback in 2022 will completely depend on the public's perception of where we are in the battle against COVID-19. If the public thinks the threat is easing and the health risk generally is low, they will resume shopping in person and dining in restaurants, which will likely spur activity in the retail sector. Additionally, any comeback will greatly depend on the availability of labor and the supply chain.

Search Retail Leasing Toolkit (National and Select States) for a collection of resources to assist both landlords and tenants in effectively negotiating, drafting, and amending retail leases.

TRENDS IN DEAL FLOW

What are the main factors that contributed to the substantial increase in deal flow in 2021? Is this trend likely to continue in 2022?

Brad Kaufman

I think that banks finally realized that, to avoid owning huge portfolios of distressed real estate, they had to cooperate with owners in getting deals done. Owners also became more realistic in determining their asking rents and providing concession packages to already stressed tenants.

Claramargaret Groover

The availability of funds was an important factor that contributed to deal flow. US consumers reportedly accumulated $2 trillion in excess savings in 2021. Fewer bankruptcies occurred in 2021 because capital was available to purchase distressed properties, and owners were able to avoid fire sales. An increasing number of developers and contractors anticipate rising profit margins, even taking the tight labor market, inflation, and supply chain issues into account. Therefore, I expect the trend of increased deal flow to continue.

Kathleen Wu

Pent-up demand from the slowdown in the early days of the pandemic fueled some of the 2021 boom. Other important factors included low interest rates, the large amount of investable cash held by private equity firms, and banks' willingness to lend. All of that added up to a great year for deals (and deal lawyers).

There may be fewer attractive targets left to buy given the high valuations resulting from the 2021 boom, which could cool the pace of deals in 2022. Also, as I write this, there is talk of higher interest rates on the near horizon, so that cooling may come soon. The recent prediction of a global economic slowdown further dampens the outlook. For better or worse, however, the slowdown probably will not significantly affect the deal market in the US (or other developed economies) as much as it will in less developed countries.

Search Commercial Real Estate Loan Drafting for National Lenders Toolkit (Select States) for a collection of resources to assist commercial real estate lenders in customizing standardized, jurisdictionally neutral form loan documents that are enforceable and recordable in select states.

Andrew Lance

Deal flow increased due to factors such as the shifting demand among asset sectors and geographic focuses arising from sea changes in consumer behavior, as well as changing priorities regarding the need for and use of space, the impact of low interest rates, and the powerful incentive to harvest gains due to the proposed increase in capital gains tax and other tax changes adverse to real estate investors (which did not materialize). I expect these factors to moderate but persist in 2022, with the moderation offset by the need for users to manage supply chain issues and for investors to deploy capital and improve returns.

Stuart Saft

The $4 trillion of government stimulus in 2020 spurred deals when it hit the market. The $1.9 trillion of government stimulus in 2021 then raised concern that we would enter an inflationary cycle, so the smart move was to buy real estate and other hard assets. Due to very low interest rates, financing for the purchase and development of real estate could be obtained inexpensively and likely repaid with cheaper dollars, given the anticipated inflationary cycle. Additionally, the appetite for dealmaking was strong following restrictions during the worst of the pandemic, and the availability and effectiveness of vaccines raised expectations about a return to normalcy. Senators Joe Manchin and Kyrsten Sinema also provided hope that we would not be taxed into an economic depression. And finally, the optimism of real estate professionals boosted the increase in deal flow.

Jennifer Chavez

The main factors supporting new deals were strong consumer demand for housing, increased online shopping, a strong economy in general, and the world becoming more comfortable with resuming activity despite the COVID-19 pandemic. The trend of strong deal activity is likely to continue in 2022.

However, the hyper-contagious Omicron variant currently is disrupting day-to-day life in a way that many hoped would not happen in a post-vaccine environment. Future COVID-19 variants could again upend progress toward recovery. These disruptions could have a negative impact on the economy, especially the entertainment, retail, and hospitality sectors. While the potential effects are unclear, I think the Omicron variant will be a blip that does not have a lasting impact.

The housing and logistics industries never really slowed down when the world had to shelter in place, so I am hopeful those industries will continue to thrive. I anticipate that the real estate and construction markets will continue to be busy through 2022.

Search Real Estate Global Coronavirus Toolkit for a collection of resources to assist counsel working on epidemic, pandemic, and business interruption issues.

RESIDUAL EFFECTS OF THE COVID-19 PANDEMIC

Given that an increasing number of companies are implementing their return-to-office plans, has there been an uptick in office leasing? Is office space being converted into other asset classes, such as hotels, residential units, or affordable housing? Does any conversion trend extend to other asset classes, such as retail-to-life science conversions?

Andrew Lance

Leasing activity has been steady for us throughout the pandemic, but there have been changes in how space will be used. Office leasing activity is building. The present level of demand is likely to continue, and there could be an increase due to emerging clarity on policies regarding office presence.

Conversions of hotels to a different class of hotels, or to residential and other uses, have occurred. Retail space is being converted to a broader set of uses, and we are seeing broad interest in health and life science uses. Residential space typically remains residential, and strong demand is returning or already has returned for properties that are competitive based on amenities, quality, modern systems that can support work-from-home needs, location, and price (for those seeking to capitalize on lower occupancy costs). We are watching to see the market response to the recent announcement by the New York governor and the New York City mayor of their intention to encourage residential conversion in midtown Manhattan.

Jennifer Chavez

I am not currently seeing a rise in office leasing. Companies unfortunately retreated to a work-from-home environment as a result of the Omicron variant, but I anticipate that employees will get back to the office on a regular basis again soon.

We have seen developers pursue entitlements that allow a flexible range of land uses so that office, residential, and even tourist hotel (for example, VRBO) uses are permitted by right in a single building. Some of this was happening before the COVID-19 pandemic because developers were trying to create mixed-use developments that could easily adapt to market conditions. We see more thinking about how to maximize the types of land uses that can be permitted in a project on the entitlement side as a result of COVID-19, but I personally have not seen many efforts to convert existing office or other uses.

Brad Kaufman

I have not yet seen an uptick in office leasing, but it is coming. With large banks and other employers across the board offering (and sometimes mandating) work-from-home policies, there continues to be significant unutilized, or certainly underutilized, office space. Owners will ultimately take measures to re-establish cash flow from their buildings.

Kathleen Wu

Office leasing has not surged back to its previous levels, in my experience. Although many companies have returned to the office, many others are still allowing employees to work from home at least a few days a week. This wide variability is causing some companies to rethink their configurations (and theoretically delay expansion plans). A new COVID-19 variant seems to emerge every few months, which spooks the market and causes companies to rethink their leasing plans again.

I have not yet seen conversions of office space into other asset classes. It is not as profitable, so unless there is an overwhelming amount of empty office space, and it remains empty for an extended period of time, I do not foresee this becoming a major trend.

Stuart Saft

There have been some preliminary conversations about office space conversion. The general belief seems to be that while the use of office space may change, fundamentally it will remain the same.

My colleagues are virtually unanimous in their desire to return to the office, but they have concerns about the danger in public transportation and the inability to bring cars into the city because of the limited number of garages. New York City's plan to reduce traffic flow and limit the construction of garages has now backfired because employees who live in surrounding areas prefer working from home over commuting to the city, where they risk contracting COVID-19, being mugged, or waiting for a train that is always late. The central business district remains barren. Until the public transportation system is improved and people feel they can get to work safely, the city's income stream will be adversely affected.

Claramargaret Groover

The trend in leasing office space appears to be the reconfiguring of existing tenancies to allow employees to utilize office space on a staggered, visitor basis. This trend is moving slowly, perhaps in light of some forecasts that employees' work quality and productivity will be enhanced by the ability to collaborate in the office.

Search Office Leasing Toolkit (National and Select States) for a collection of resources to assist landlords and tenants in understanding and effectively negotiating their office leases.

Search Hospitality Law: Overview and Key Issues in Financing Hospitality Properties for information on real estate transactions in the hospitality sector.

LEGISLATIVE IMPACTS

In what ways might the Build Back Better legislation or new climate legislation affect the real estate market and change how market participants do business? Is there any other proposed legislation that market participants should monitor?

Kathleen Wu

At this point, it does not look like Build Back Better is going to pass. I suspect some of the climate change provisions may be reintroduced, but they will be smaller than what was in Build Back Better. Likewise, there were investments in affordable housing that may come back in another form. Major investments in those two areas would likely impact my clients, but I am not placing any big bets right now.

Jennifer Chavez

I do not anticipate that the legislation will have much of an impact on private real estate deals. In projects where a developer is required to construct a piece of infrastructure, such as a bridge, we have seen some inquiries about the ability to use funding from the legislation, but I do not believe it is driving deals.

Additionally, I do not expect new climate change legislation to have a tangible impact in California. At both the state and local level, California is already implementing climate change legislation. That implementation is making construction more expensive, especially for projects outside urban areas that must provide mitigation for an increase in "vehicle miles traveled" resulting from a project.

Developers in California are always on alert for new housing legislation. We are also watching legislation aimed at restricting development in areas that are at high risk for wildfires, which tends to be exactly where much needed housing is planned for development in California.

Stuart Saft

I do not expect that Build Back Better will be enacted, and certainly not in its current form, now that the true cost is more transparent to the public and we are entering an inflationary cycle, which likely will continue for a few years. The approximately $6 trillion of stimulus that I discussed above will create about $40 trillion in spending money, which will feed a lot of inflation. I also think the climate legislation will be amended to make the requirements less rigorous, considering the cost to the economy and the likelihood that we will have a recession to stop the inflation.

Claramargaret Groover

The infrastructure legislation is already having an impact on the bidding of public construction projects and increasing construction jobs in anticipation of funding. Projects that are planned or already underway qualify, as well as new ones not planned yet. Governors have the ability to direct funds to projects without legislative action. Federal funds will also be available through competitive grants requiring state and local matches. Companies involved in public construction contracting, as well as private companies that are being granted tax incentives for development in the manufacturing sector, are already planning and designing real estate improvements.

Search Infrastructure Investment and Jobs Act of 2021: Key Infrastructure and Energy Provisions for information on key transportation infrastructure and energy provisions of the $1.2 trillion Infrastructure Investment and Jobs Act of 2021.

Andrew Lance

It is hard to say now what proposed legislation will be enacted. There is increased focus in New York on Local Law 97, which requires large buildings in New York City to meet certain energy efficiency and greenhouse gas emissions limits by 2024 (and stricter limits by 2030). The New York City mayor is resetting several priorities, which state legislators in Albany will need to digest and then will negotiate to reflect budget priorities in due course.

Search Biden Administration Energy and Climate Change Policies and Regulations: 2022 Tracker for information on key Biden administration actions and initiatives taken in 2022 on climate, energy, and environmental issues.

SUPPLY CHAIN ISSUES AND LABOR SHORTAGES

What are the short-term and long-term effects of supply chain issues and labor shortages on construction and development?

Brad Kaufman

Alleviating supply chain issues and labor shortages is critical in the retail sector. If stores cannot stock their shelves and restaurants cannot operate, they have no business. Restaurants in particular have been the hardest hit. Supply chain and labor issues have caused restaurants to close, change or cut back their menus due to a lack of supplies, or reduce their hours or use less of their space due to inadequate staffing.

Retail leasing has also slowed down as retailers try to determine what goods will be available for sale and when and how they can staff stores. While I do not believe this is a long-term problem, it is unclear when these issues will be fully resolved.

Stuart Saft

Supply chain issues are a serious problem, and the US should respond by bolstering the supply chain in North and Central America rather than continuing to produce most goods in Asia. The current bottleneck could be reduced by transporting supplies on trucks and trains that can travel anywhere instead of importing supplies through ports in California, especially now that the state's new environmental rules make it difficult to obtain the deliveries. Many areas, especially in the Rust Belt, can duplicate what China has done.

Of course, that would mean that Americans would face slightly higher prices because of higher labor costs to produce the merchandise. The unions would also have to be more cooperative in their dealings with management.

Claramargaret Groover

Pricing and contracting to anticipate supply chain issues and inflationary pressures continue to burden contractors and owner-developers. Cost-plus contracts with and without a GMP continue to be an effective tool to get projects started. Construction labor shortages are an ongoing problem in the industry, which struggles to replace retiring baby boomers who exited the workforce in the aftermath of the 2008 financial crisis or less experienced younger workers who may have dropped out as part of the COVID-19 re-evaluation of their career paths.

Andrew Lance

There have been shortages generally in materials and manpower, and these issues have had an impact on construction and development, and caused pronounced disruption in retail, restaurant, and hospitality businesses. Increasing wages has been the primary response to labor shortages. While many vendors are increasing orders, they are not getting the goods and do not expect them for an extended period of time.

Kathleen Wu

Higher costs due to supply chain issues and labor shortages are affecting everyone, and it has led to delayed and even canceled projects. And it has definitely cut into profitability. In the short term, some employers are offering hiring bonuses and other incentives to attract and retain workers, but long-term solutions will require more systemic changes, such as greater investment in training for construction jobs and refinement of the immigration system. Unfortunately, those steps require industry-wide and political coordination and therefore are beyond the reach of individual market participants. As for dealing with supply chain issues, builders everywhere are having to think much further ahead than ever before. This means predicting material needs and securing storage space, if necessary, which is another cost.

Jennifer Chavez

I have heard about supply chain issues and labor shortages, but I have not seen it impact the pace of real estate transactions. Some clients have expressed an interest in trying to account for increases in material costs in a purchase agreement, but that gets complicated and usually is negotiated out of the final agreement.

Search Dispute Resolution Mechanisms in Construction Contracts in the US and COVID-19: Key Considerations for Privately Owned Construction Projects for information on managing construction disputes.

Search Managing Supply Chain Disruptions in a Crisis for information on legal and business issues to consider when dealing with a crisis, such as the COVID-19 pandemic, that disrupts the supply chain.

SECONDARY AND TERTIARY MARKETS

Has the increased appeal of suburbs during the COVID-19 pandemic led to more deal flow in secondary and tertiary markets? Is this trend likely to continue over the next several years?

Jennifer Chavez

Homebuilders are in these markets because that is where sufficient land exists for new subdivisions. People and industry have realized that employees can work remotely at least some of the time, and the suburbs are more attractive when long commutes can be minimized or avoided. Therefore, I think the migration to suburbs and increased deal flow in these markets will continue.

Top Resources from Practical Law Real Estate

The following is a selection of Toolkits from Practical Law Real Estate that counsel can use to address the issues discussed in this article and more.

- Commercial Real Estate Loan Drafting for National Lenders Toolkit (Select States)
- Industrial and Warehouse Leasing Toolkit (National and Select States)
- Purchasing and Selling Commercial Real Estate Toolkit
- Commercial Real Estate Development Project Toolkit
- Real Estate Joint Venture Toolkit (90/10 Real Estate Joint Venture)
- Negotiating and Drafting Construction Contracts Toolkit
- Commercial Real Estate and Construction Laws: State Comparison Charts Toolkit
- Office Leasing Toolkit (National and Select States)

Brad Kaufman

From a retail perspective, it is easier in the current market for a retailer to get a deal done in a mall if the owner and retailer have executed other deals in the owner's other locations than for the retailer to make a large commitment to an unknown street location. As a result, I have seen a small trend of retailers doing deals in locations they may not have considered five years ago.

Kathleen Wu

I have not seen this trend expand much beyond the residential market, but where people go, businesses will follow. It just may take longer than we expect, partly because of the supply chain issues and labor shortages.

Stuart Saft

No, I have not seen more deal flow in secondary and tertiary markets. I am seeing a lot of New Yorkers moving south for relief from high taxes, poor schools, and crime, so New York developers are building in other areas. However, I am hoping that Governor Hochul and Mayor Adams will stem the population decline by taking the necessary steps to make New York more attractive than other states, such as Florida.

HOT TOPICS FOR 2022

In your specific areas of expertise, what will be the hot topics for 2022? What do you anticipate will be the biggest disrupters in the real estate and construction markets in 2022?

Kathleen Wu

The infrastructure bill will mean significant investment in new construction, repairs, and updates. However, labor shortages and supply chain issues are likely to persist, so that money might actually worsen the situation for builders struggling to complete projects right now. It is similar to when workers defer small renovation projects on a house to prioritize a bigger, more lucrative project in a neighboring area. As lawyers, though, we will be looking for new ways to take advantage of the incentives and tax breaks this bill offers. There will be plenty of opportunities for those agile enough to pursue them.

Brad Kaufman

The hot topics in 2022 will be the COVID-19 pandemic and inflation. If there is another large wave of infections or a new strain of COVID-19, then I think the course of the year will be unpredictable. People have been worn down, and it is unclear how they would react to another period of restriction. Focusing on the retail sector, the effect of inflation on purchasing power is already apparent, and at this rate it will continue to worsen to the point of crippling the economy if nothing is done to stem it.

Jennifer Chavez

I am not sure there will be a "hot topic" for 2022 in the land development world. I think we will continue to see pressure on cities to approve housing projects and continued debate about where that housing should be located. Infill development will be preferred because it generally has less impact on the environment, including climate change, but California's housing demand cannot be satisfied without a good amount of suburban expansion. As for disrupters, disruption can come from many places, but I think the COVID-19 pandemic is the most likely source for 2022.

Stuart Saft

Key areas of focus in 2022 will be reducing regulations to make development easier, finding lawyers and administrative staff to handle the high workload, and reducing taxes, which requires the government to adhere to budget limits and not impose new taxes despite diminishing services.

Andrew Lance

Hiring challenges, continued development of work-from-home policies, and state income taxes are the hot topics to monitor in 2022.

Claramargaret Groover

Inflationary pressure is expected to be the wildcard, and a shortage of experienced and trained design and construction professionals and workers will continue to burden developers and contractors in design and construction projects. PL