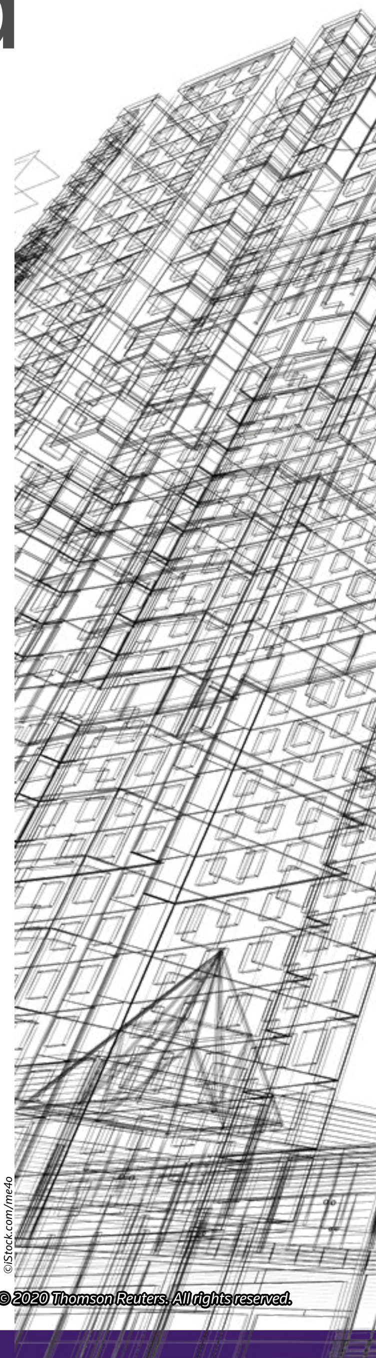
Commercial Real Estate

A Look at 2019 and Planning for 2020

Practical Law Real Estate asked leading real estate practitioners to share their thoughts on recent trends and developments impacting the commercial real estate market and provide predictions for the year ahead.



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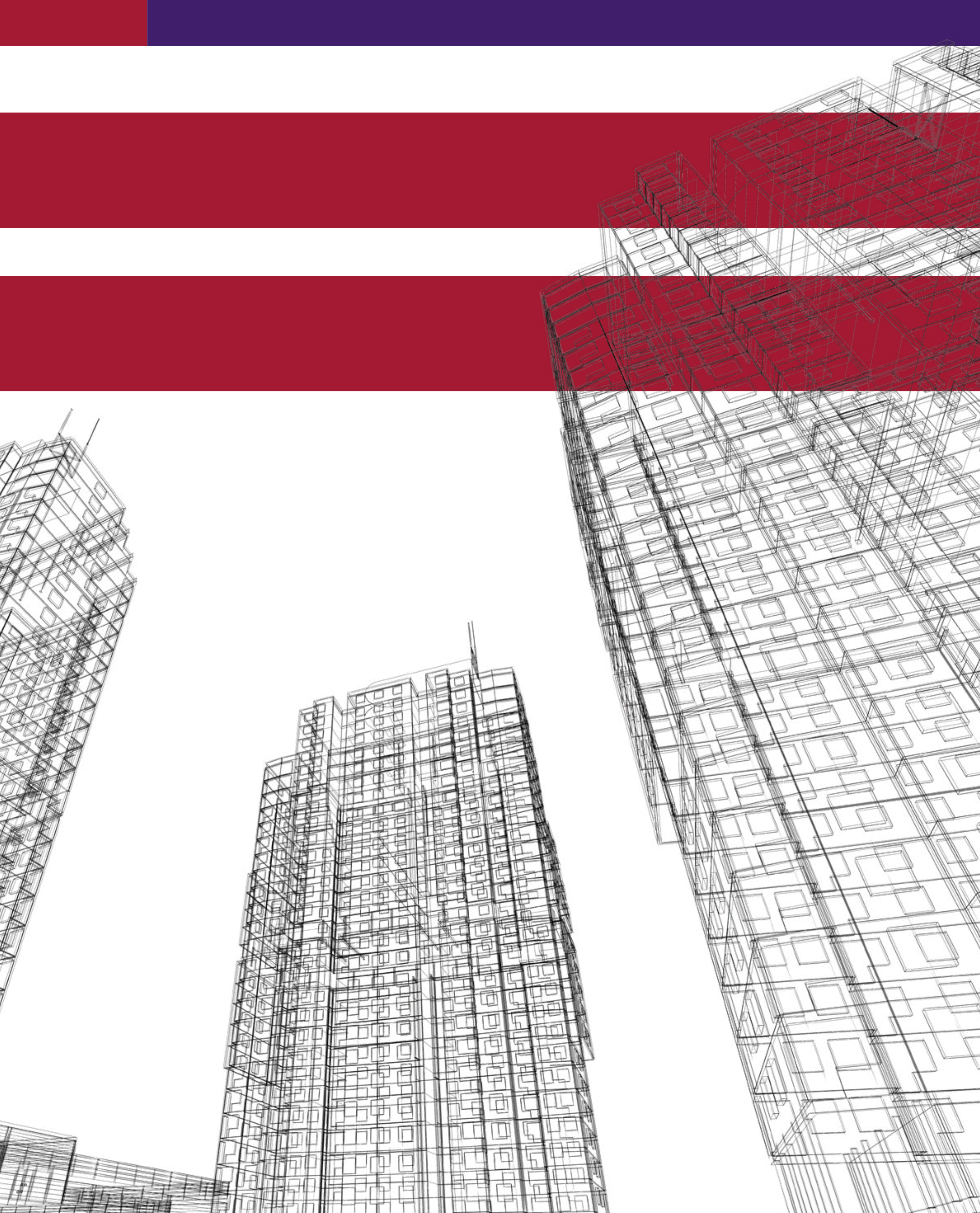
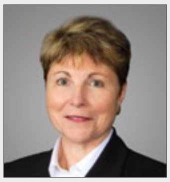


CONTRIBUTORS



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

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Stuart is 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 throughout the US.

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In the midst of political uncertainty both in the US and abroad, 2019 proved to be another robust year for commercial real estate in the US, with a focus on new investment opportunities and emerging niche markets. Foreign investment remained strong and the emphasis on fundamentals continued to be important. However, changing market forces and a potential end to the current growth cycle are front of mind for many real estate investors as they look toward 2020.

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

- A review of 2019 market trends and developments.
- The status of foreign investment in US real estate.
- The phaseout of LIBOR and conditions in the capital markets.
- The emergence of the shared workspace model.
- The outlook for the retail market.
- Niche areas of real estate law and practice.
- Predictions for the future.

2019 MARKET TRENDS AND DEVELOPMENTS

With the benefit of hindsight, how did the state of the real estate market in 2019 differ from your predictions? What developments have surprised you?

Andrew Lance

The real estate market is part of the larger economy, and I, like most practitioners, would not have predicted the very strong economic performance in 2019. The record low unemployment rate, increase in real employment income, and investment returns on public securities exceeded reasonable expectations, both absolutely and in the face of turbulent world events and US politics.

That being said, the continued downward trend for retail space was predictable, and the upward velocity of demand for hotels and warehouse/distribution/fulfillment space remains consistent with expectations. The enactment of new laws regarding rent stabilized housing in New York City was a surprise and already has had a significant depressing impact on values for rent stabilized residential properties.

Stuart Saft

A year ago, I believed (and still do) that the economy was strong, a recession was not likely to occur prior to the end of 2020, and the inverted yield curve was insignificant because the paradigm had changed so much since the last recession. I was impressed (and still am) by the strong economy, low inventory buildup, low interest rates, low unemployment, available credit, energy independence, and strong dollar. I did not think (and still do not) that the political climate or global unrest would have an impact on the US or the US real estate market.

What has surprised me is the rent stabilization legislation enacted by the New York City Council and the New York State Legislature, which could have a negative impact on both the commercial and residential real estate market in New York State in general and New York City in particular. The legislation will have a significant impact on New York's financial standing, because real estate produces substantial revenue, as well as impact its credit rating and the interest on its bonds. These conditions are reminiscent of the 1970s when people moved out of New York City in substantial numbers, buildings were abandoned, new construction projects were not undertaken, and lax enforcement of the laws led to a crime wave.

Andrew Van Noord

I think most real estate practitioners were expecting a slight downturn that has not materialized yet. While there has been a flattening, we never hit the expected recession and the demand for quality real estate assets remains strong. Given the large amount of capital waiting to be deployed, I do not think the performance of the 2019 real estate market was really all that surprising. Market participants were cautious (and will continue to be), but the fundamentals were still there.

Have you seen any noteworthy real estate trends in 2019? Are any states standing out in terms of investment and development activity and, if so, what is driving that heightened activity?

Andrew Lance

There is continued interest in the development of new work environments, including both office space in the conventional model and a variety of different configurations of work environments. It is exciting to see the critical thinking and design creativity that generates changes not only in the buildings, but also in the character of work environments, and in turn the way work integrates with our non-work lives.

Continued capital investment in our cities and in the quality and innovative nature of the inventory of commercial space generally also is great to see. These trends are essential to create employment opportunities and to maintain and enhance regional and national competitiveness. The imagination and ingenuity behind projects such as Hudson Yards in Manhattan and numerous properties in Northern and Southern California, the Dallas-Fort Worth and Houston, Texas areas, Nashville, Tennessee, and many areas in Florida is inspiring. Many of these developments rethink the work environment entirely, while others rejuvenate or replace tired buildings and upgrade building systems for more modern functionality.

Claramargaret Groover

Florida continues to be a favorite for foreign and domestic investors, especially in Miami and other areas of South Florida. High-end residential and mixed-use development continues throughout the state and multi-family rental properties remain the preferred model in many urban areas. Central Florida is experiencing a residential construction boom as well.

Andrew Van Noord

Texas remains very strong. The numerous corporate relocations to Texas are driving incredible growth, with many Texas cities among the fastest growing in the last few years. Texas is very attractive for corporate relocations from a tax perspective and has a diverse workforce. Most of those relocations are from the coasts, but we are seeing more from the Midwest as well. With all of those relocations, we will continue to see a strong tax base, steady employment, and demand for housing and office space. Additionally, with the industrial real estate boom and Texas' proximity to Mexico and a major trade thoroughfare, we will see increased investment in real estate.

Kathleen Wu

We are still seeing significant real estate activity in Texas, both in the big urban centers and in the suburbs. As a Texan, I am ambivalent about this because of how much aggravation it adds to my commute. However, as a real estate practitioner, it is nice to see so much development close to home.

However, Texas is not alone. There are many other hot spots, including North Carolina, Florida, parts of Georgia, and certain secondary cities in California, such as San Jose and Sacramento. The cost of living and doing business in major cities is a huge driver. Companies are moving out of the "hubs" and into smaller cities, and people follow to where the jobs are. New York, Los Angeles, Chicago, and Washington, DC will always be hubs, at least for the foreseeable future, but it is encouraging to see so much real estate activity in other parts of the country.

Stuart Saft

Many developers, investors, and lenders are focused on the Southeast, particularly Florida, because of its lack of an income tax, limited regulations, and strong economy.

However, because it takes ten years to locate, finance, and build in New York, the impact of what has happened in 2019 will not be felt for one or two years and cannot be changed for a decade.

FOREIGN INVESTMENT IN US REAL ESTATE

Is US commercial real estate still viewed as a solid investment for foreign money? Have you seen any negative impact on foreign investment due to the current US political climate?

Kathleen Wu

I try to avoid making predictions because there is significant upheaval in both the US economy and the political environment, and those changes have not always resulted in what the experts have said they would. With that caveat, I believe that US commercial real estate is still seen as a solid, stable investment by foreign investors.

There have been challenges (for example, trade disputes) and there was some pullback in 2019. However, the fundamentals of the US economy remain relatively stable and we seem to have maintained investor confidence, for the most part. My chief concern is that events overseas, including the always unpredictable Brexit situation and the instability between China and Hong Kong, will affect the US economy in ways that we are not able to foresee and cannot control. Nevertheless, the presence of instability abroad only makes investing in the US a better bet.

Andrew Van Noord

There has been some pullback of foreign investment in 2019 as compared to 2018 (which was an exceptional year for foreign investment), but foreign investors will continue to invest in US real estate because it is a stable asset class that generates solid returns. China has not been as active due to their restrictive monetary policies, but other foreign investors made significant portfolio investments that helped tip the scale back.

However, foreign investors are competing for deals and I would not be surprised to see another slight pullback from foreign investors given the political uncertainty in the US.

Andrew Lance

The US remains not just a solid investment, but the solid investment globally for investment capital. While the current US political climate is not a positive factor in investment decisions, the deterrent impact is overshadowed by the breadth and depth of positive indicators and the absence of compelling investment alternatives in markets which are deep enough to absorb the demand for investment capital, and which provide the security of the reliable rule of law. Anything that would undermine of the rule of law in the US may be of even more consequence than political turbulence for long-term investment decisions by foreign investors.

Stuart Saft

I have not really seen any negative impact on US investment as a result of the US political climate. As long as the economy remains strong, political battles will have no impact. However, there is a great deal of concern that the results of the next presidential election may cause the stock market and economy to experience significant declines. Given that 50% of the stock market is held by pension and other retirement funds, a market collapse will devastate the middle class who are relying on those funds to retire.

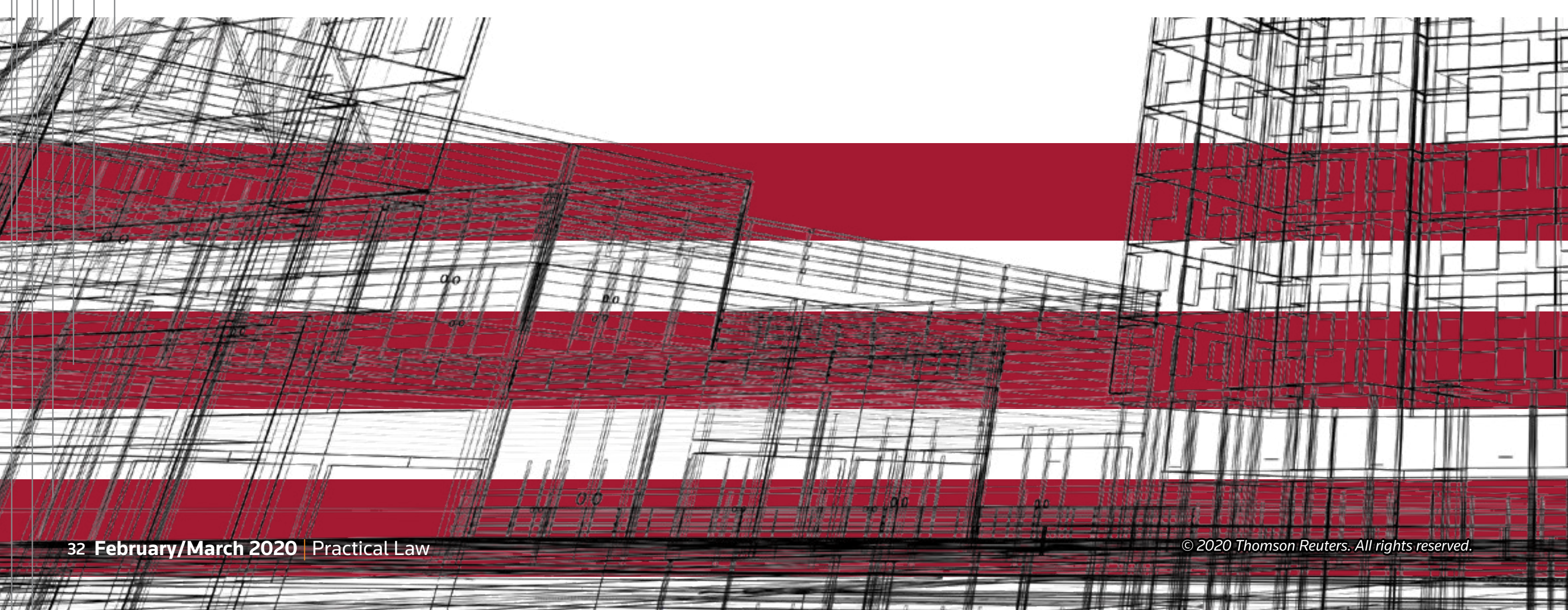
Who are the primary foreign investors in the US market? Are they investing in major cities or are they branching out to secondary or tertiary markets?

Stuart Saft

Money is coming into the US from around the world and investments are being made in all asset classes. Investors are still investing in major cities, but they are looking at secondary and tertiary markets to diversify and spread the risk. New York City has become less attractive because the prices are so high, but also because the market has become a buyer's market and buyers are waiting to see how low the market will go.

Andrew Lance

A variety of foreign investors are active in the US, from high-net-worth individuals and individuals investing through funds, to institutional investors of all types, including sovereign wealth funds, to strategic buyers. Real estate investing has extended well beyond major cities for a number of years and continues to do so. The increased interest in warehouse/distribution/fulfillment properties requires branching out to every geographic area of the US.



Andrew Van Noord

Foreign investors have started to focus more on growth cities and other gateway cities as they seek higher returns. Given the competition for high-performing assets and their increased knowledge of the real estate market, foreign investors are not as hesitant to seek opportunities outside of the major cities.

Kathleen Wu

According to Bloomberg, Canada was the largest foreign investor in the first half of 2019, with $5.3 billion of US commercial property deals. This was followed by Israel, Germany, the United Arab Emirates, and Bahrain, with approximately $1 billion each. (See Bloomberg, Foreign Investment in US Commercial Property Drops Almost 50% (Sept. 9, 2019), available at *bloomberg.com*.)

What types of deals are foreign investors focused on and are these investors entering into joint ventures with US partners or investing alone?

Andrew Van Noord

We have seen a broad range of foreign investments, but foreign investors mainly partner with local operators. They rely on their US partners' knowledge and expertise to operate and execute their business plans.

Andrew Lance

Joint ventures with experienced domestic partners have long been attractive to foreign investors, both as an investment model and as a gateway to investing independently. REIT structures and successive transfers of 49% interests, which do not trigger steep transfer taxes, remain common. In terms of asset classes, it is all across the board.

Stuart Saft

Foreign investors are either engaging in joint ventures with a local partner or hiring local advisors for guidance.

Search Commercial Real Estate Joint Venture Agreement Checklist for information on the issues to consider before setting up a commercial real estate joint venture and drafting a commercial real estate joint venture agreement.

Search Real Estate Joint Venture Toolkit (90/10 Real Estate Joint Venture) for resources to assist investors, developers, and other parties forming a commercial real estate joint venture.

LIBOR AND THE CAPITAL MARKETS

How are real estate transaction parties addressing the LIBOR phaseout in transaction documents? Do you foresee these tactics changing once the phaseout is complete in 2021?

Kathleen Wu

Some of my clients are participating in the group created to find a solution by the end of 2021. In the interim, most lenders are incorporating language with a LIBOR successor rate definition. It is a temporary fix. Once we know what the replacement will be, transaction documents will start referencing it, but I suspect there will still be successor language to address any future changes.

Andrew Lance

There is not a uniform approach, and there often is attempted risk shifting that seems unwarranted. The governing principle should be to get as close economically to what the result would have been had LIBOR remained applicable.

Stuart Saft

Right now, it is chaotic because there is no standard and LIBOR really worked well for a very long time. It will take one or two years after the phaseout for the situation to solidify.

Given the availability of capital in the commercial real estate market, have you seen a noticeable trend toward "lightening" of lender covenants or an increase in lender flexibility?

Stuart Saft

Quite the contrary. I have seen lenders (or at least their attorneys) get tougher because of the uncertainty.

Andrew Lance

I have not seen this occurring, but I have not seen many high-leverage transactions. More conservative levels of leverage may be a more important factor in operating flexibility for borrowers than a deep pool of capital looking for a home.

Claramargaret Groover

Condominium and mixed-use developers have not seen any relaxing of strict lender covenants on new projects. Developers are concerned that lenders are more inappropriately involved in day-to-day construction inspection and management.

We expect that lender involvement in projects could lead to an increase in lender liability claims against lenders that assert themselves as partners in the owner's operational management of the construction contract. This reaction will likely grow more serious if the market experiences a downturn due to trade tariffs or continuing instability in labor supply.

In the current interest rate environment, which financial entities are winning deals?

Andrew Lance

Funds and commercial bank/portfolio lenders are more active in our pipeline than life companies. CMBS loans are a less significant portion of the originations we see, but still are meaningful. International lenders are increasingly active. For example, we represent a number of international lenders who are particularly focused on construction lending and who have been very active.

Stuart Saft

It is spread around to all sorts of lenders and many new players from the US and abroad.

SHARED WORKSPACES AND THE TRADITIONAL OFFICE LEASING MODEL

Have shared workspaces negatively affected the traditional office leasing model? Have landlords been forced to give additional concessions or amenities to not lose a lucrative deal and have tenants been looking at a mix of traditional office spaces as well as shared office models?

Andrew Lance

I have not seen this occurring. We have represented a number of landlords in leases of one or more floors of their buildings to shared workspace operators. The shared workspace model seems to meet particular needs without (so far) materially affecting traditional office leasing.

Andrew Van Noord

Landlords are definitely responding to the shared workspace demand and are getting more creative in their leasing and amenities. They are developing their own shared workspace platforms and offering tenants incentives, such as flexible space.

Landlords know there is demand for that type of space, and even the traditional tenants have expressed desire to be in buildings with shared workspace available, so landlords have to be responsive. At the same time, landlords are also more cautious in signing up leases with shared workspace operators.

Stuart Saft

If WeWork's IPO had been successful everything might have changed, but that was not the case because it became clear that the model did not work. Traditional landlords have been left holding the bag to some degree, although it is the lenders who took the biggest risks.

I think we will see landlords testing out their own shared workspace models on one or two floors in a large building. The underlying concept was always questioned by landlords because history has shown that when a recession occurs, the people using shared workspaces simply return to their kitchen tables and avoid paying rent. Landlords have always protected themselves, but were able to unload high-priced space in what could have been a soft market because no one expected the recovery to last over a decade. The market for office space has remained strong and continues to be strong.

RETAIL OUTLOOK

Is there hope on the horizon for the retail real estate market?

Kathleen Wu

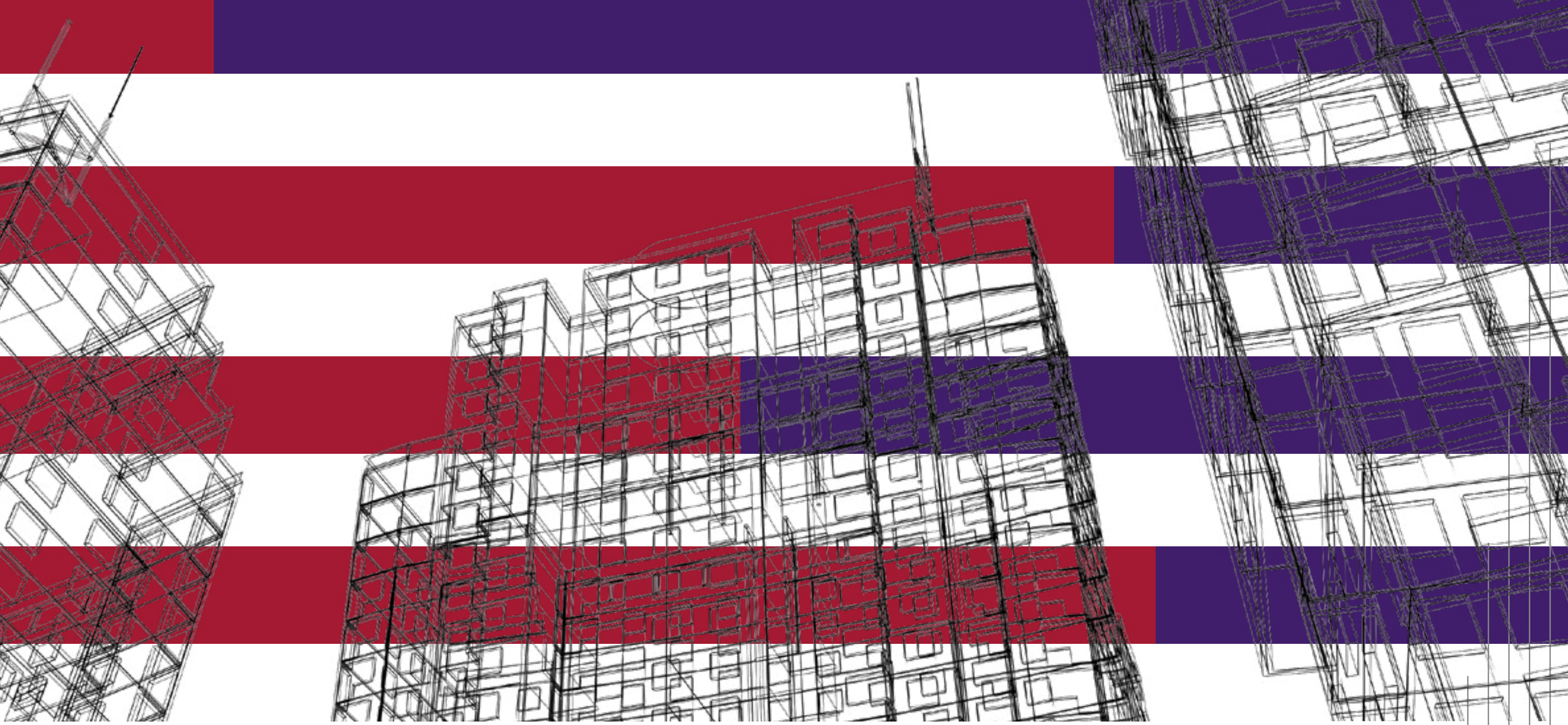
Mixed-use developments present a significant opportunity in retail. Even in the car-centric cities of the South, people are gravitating toward living in more densely populated areas where they can live, shop, work, exercise, and dine all within walking distance. Mixed-use developments, particularly those that include green space and sustainable elements, appeal to both young professionals and empty nesters.

Retail has had its share of problems in the last few years, and mixed-use developments certainly are not going to save traditional retail, which continues to face stiff competition from online retailers. However, retailers that sell an experience as much as they sell a product, particularly those that can provide foot traffic in mixed-use developments with a reason to step inside, have reason to be optimistic.

Andrew Lance

Retailers that reinvent their presence regularly give consumers a reason to visit their stores and will continue to do well. Conversely, retailers who cannot clearly articulate and execute their value proposition compared with online retailers will not succeed.

There are numerous examples of unique and energized retailers who thrive. For example, Wegmans attracted large crowds for its opening in the Brooklyn Navy Yard. Additionally, Amazon's purchase of Whole Foods illustrates that even companies that understand online retailing recognize the enduring value of a brick-and-mortar presence. Retailers need to be continuously



focused on how to maintain the relevance and magnetism of their enterprise.

Andrew Van Noord

It is hard to see how retail will recover in the near term with the meteoric rise of online retailers. The traditional brick-and-mortar retail model will continue to suffer because the demand is simply not there.

We will see more complete retooling of large retail space that focuses on creating more of a live, work, play destination than typical merchandise retail. Owners and developers are looking to redevelop these spaces with restaurants, movie theaters, and entertainment.

However, the high-end, destination retail "experience" will continue to do well. We have seen some of that already in North Texas, where large shopping malls have been demolished or repurposed, and office or hotel properties are being developed with multi-family and entertainment components, with a smaller retail footprint.

Stuart Saft

Landlords are becoming more flexible because the soft market has continued for two years, so rent and other concessions are being offered.

Search Retail Lease: Key Provisions for more on the key provisions found in retail leases, including drafting and negotiating guidance for landlords and tenants.

Search Letter of Intent for a Retail Lease (Pro-Landlord Long Form) for a model pro-landlord form of letter of intent for a lease between a landlord and a non-anchor tenant in a retail shopping center, with explanatory notes and drafting and negotiating tips.

NICHE PRACTICE AREAS

Are there any niche areas of real estate law that your practice group or firm focused on in 2019?

Andrew Lance

Both our equity joint venture business and our debt financing business were explosively busy in 2019. We also handled an unprecedented volume of large office leases. We do a lot of ground-up development work, especially in the public-private partnership space. For example, our projects in 2019 included sports arenas and stadiums, performance venues, and similar special use concepts nationwide, which are challenging and fun to work on.

Claramargaret Groover

We continued to expand our firm's public-private partnership legal representation and utilized this financing model for university residential and student amenity developments, both domestically and internationally, in 2018 and 2019.

Additionally, the firm developed its natural disaster insurance recovery process for community associations and other clients that present claims for construction repairs. The service involves fewer consultants and results in a cost-efficient approach to remediate storm damage on the properties.

Stuart Saft

We continued to service all our clients and continued to draw new clients.

Is the cannabis industry impacting your clients?

Kathleen Wu

I have not seen much of an impact on my clients, although it is clearly a growth industry (no pun intended). The barriers to entry, particularly challenges in obtaining financing, are substantial, given that marijuana is still illegal under federal law, regardless of what the states allow. If those barriers are lowered or eliminated, I anticipate a flurry of activity among every conceivable player in commercial real estate. For the time being, though, it has not affected my work in a meaningful way.

Claramargaret Groover

Cannabis laws are impacting condominium associations and their property management and regulation. These laws are requiring updates to governing documents of condominium and homeowner associations to regulate unit owners and their tenants with proper deference to unit owners' rights to privacy. We have also represented a grower in the construction of its agricultural operations.

Have you seen significant interest in Qualified Opportunity Zone (QOZ) investments?

Stuart Saft

I worked on several QOZ deals before the regulations were enacted, but interest in these deals has waned. Most of our clients would prefer to either pay the capital gains tax while they can or engage in Section 1031 exchanges. When you take a closer look at QOZ deals, there are too many risks for the reward that might not be realized for a decade.

Andrew Lance

We saw significant interest in QOZ deals, but not a lot of actual investment.

Search Qualified Opportunity Zone Investments: Overview and Qualified Opportunity Zone Investments Flowchart and Timeline for more on the benefits and requirements of the QOZ program created under the Tax Cuts and Jobs Act.

Search 1031 Like-Kind Exchange of Real Estate Toolkit for resources to assist counsel for purchasers, sellers, and investors in understanding, negotiating, and closing a 1031 like-kind exchange of real estate.

PREDICTIONS FOR 2020

What are your predictions for the real estate market in the year ahead? Do you believe a recession is looming?

Andrew Lance

I anticipate continued development, in-flows of capital from outside the US, and continued preference for investing through joint ventures. I also expect to see greater strength in urban areas. Additionally, apart from rent stabilized residential and luxury residential property, there will be continued improvement in values.

A recession will not be due to the fundamentals of the real estate market, but when you look at world events it is hard to make predictions amidst black swans.

Stuart Saft

A great deal depends on what happens in the presidential election in November 2020. If certain democratic candidates are nominated, I expect that selling will begin long before the election.

Kathleen Wu

We are still planning big projects and will continue to see deals in various stages. Again, I am not in the prediction business, but barring a major cataclysm, I anticipate a busy 2020.

Any recession will not approach the 2008 downturn, but the experts I am following anticipate a definite slowdown in the next year or two.

Andrew Van Noord

The industrial space will continue to be very active. I expect to see more consolidation and large portfolio transactions. Even with the increased demand for industrial space in the last several years, e-commerce will continue to grow and keep driving that demand for warehouse and industrial space. Consumers do not need or want the traditional brick-and-mortar model for typical consumer goods that they can easily buy online. That trend will not slow down. The last mile delivery and fulfillment centers are going to become increasingly hard to find. I expect to see more multi-story warehouses in markets with high land costs.

Similar to 2019, we are still on the lookout for a slowdown. The current decade-plus upcycle cannot last forever and everyone wants to know when it will end. However, the concern has moved away from full-on recession to looking for signs of corrections in the market. I expect there will be more smaller corrections or flattening in 2020. PL