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How to turn uncertainty into a corporate real estate opportunity

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ABSTRACT

This paper reveals how companies can use their corporate real estate (CRE) to emerge as a winner post-pandemic. Readers will learn how to leverage the lessons learned during the largest work-from-home experiment ever conducted; how to win the talent war as it intensifies; and how to capitalise on an extraordinary opportunity to compete, along with which companies are ideally poised to do so. Additionally, readers will be exposed to some of the trends emerging in lease negotiations for CRE leases, including lease terms, force majeure clauses, termination options, renewal options, standardisation of acceptable lease terms, reliable lease data, and how key performance indicators are being utilised.

Keywords: pandemic, lease data, trends, lease terms, lease trends, work from home

LEVERAGE LESSONS LEARNED DURING WORK-FROM-HOME EXPERIMENT

From Paris to Pittsburgh and beyond, a question asked frequently by company leaders is what to do with corporate real estate (CRE) when so much uncertainty remains in the wake of the COVID-19 pandemic. We answer this question below, and reveal lessons learned from the largest work-from-home experiment ever conducted, as well as how to capitalise on an extraordinary opportunity to compete and win the talent war. The valuable lessons of the last 18 months should be leveraged to support workplace strategies that ensure success. Here is what employees and employers are telling us.

A study by Iometrics,1 a workplace services firm based in Irvine, California, reveals that most employees working from home are more satisfied with projects in which they work independently while they are less
satisfied with work involving others, such as collaboration, coaching and mentoring. As for well-being, the majority eat healthier and many like the extra time it provides to exercise. Additionally, nearly half of the avoided commute time is used for additional work, which is increasing productivity. Now that employees have adjusted to working from home and the technology is in place to support this, most want to work at home two and a half days a week post-pandemic and feel so strongly about this that studies confirm up to 60 per cent of employees would consider resigning if their company does not establish a hybrid work policy.

There have also been valuable insights revealed over the last 18 months from employers about satisfaction, productivity and a hybrid work solution. Our experience reveals that while employers have seen productivity increase as a result of working from home during the pandemic, they want the majority of employees to return to the office at least three days a week in order to maintain an essential and cohesive corporate culture, with some exceptions being made for those who work on projects independently.

**CAPITALISE ON AN EXTRAORDINARY OPPORTUNITY TO COMPETE**

The current uncertainty has created extraordinary opportunities for companies to compete by capitalising on corporate real estate strategies that take advantage of a pandemic-induced real estate slump, during which landlords and economic development leaders have generally become more innovative and aggressive in retaining and attracting tenants and businesses. This situation allows for the creation of a variety of strategies that ensure resilience of business operations.

Despite the dramatic reduction in office leasing activity during the pandemic, it should be noted that certain industries have continued to excel and capitalise on attractive CRE opportunities that position them to compete. Microsoft, for example, accounts for three of the largest five new US office leases completed since the pandemic outbreak, including 523,000 sq. ft in Atlanta, Georgia, nearly 397,000 sq. ft in Reston, Virginia, and some 247,000 sq. ft in Redmond, Washington, as a result of its business clearly benefitting from employees using Microsoft Teams and PC software to effectively work from home or remotely, according to CoStar. We have also seen growth among other technology, cybersecurity, life sciences, e-commerce, online payment, gaming, music streaming, social media and communications infrastructure companies.

The norm over the last 18 months for a majority of companies, however, has been to provide short-term solutions in the form of lease extensions, exercising termination options, subleasing space, entering into flexible arrangements for co-working offices or a combination thereof, all while developing post-pandemic CRE strategies. These companies are ideally poised over the next 12 to 24 months to capitalise on an extraordinary opportunity to use their CRE as a weapon to compete.

The dramatic reduction in office leasing activity has generally led to negative absorption and increased vacancies, resulting in leasing inducements being available in some buildings that were untouchable prior to the pandemic. These market conditions and innovative workplace strategies will provide many companies with the opportunity to professionally leverage their CRE requirements in order to improve lease terms or upgrade space. By way of example, if the annual rent at an office building was US$25 per sq. ft pre-pandemic for 20,000 sq. ft and the rent can be reduced by 10 per cent post-pandemic, over five years this will result in a US$250,000 cost savings for one lease; if the same figure can be duplicated for 50 leases, will provide a portfolio savings of US$12,500,000. Also, if a company was
paying annual rent of US$25 per sq. ft pre-pandemic to lease 20,000 sq. ft and an innovative workplace strategy results in the size of the space being reduced by 30 per cent, then the company can pay nearly US$36 per sq. ft post-pandemic to upgrade its space while maintaining the same total cost.

Overall, companies that will best compete post-pandemic are those that professionally innovate and implement corporate real estate strategies that take advantage of market conditions, structuring lease flexibility to ensure resilience of business operations, and legislative trends and policy shifts addressing economic development that affect site selection decisions.

WIN THE TALENT WAR
As the talent war intensifies, companies must position themselves to win by developing post-pandemic workplace strategies that are people-focused and conquer widespread concerns. Workplace strategies that will be transformational are those framed by the goals of leadership which address the overall organisational culture, identify the optimal time frame for completion, include the input of employees and address emerging trends that will affect the company, including health and wellness, technology, space allocation, work-from-home policies and workplace innovations that enhance the employee work experience and increase productivity.

While upgrading the quality of office space will continue to be an effective strategy for retaining and attracting top talent, there is no doubt that protecting health and wellness is also top of mind for employees, particularly as companies roll out their return-to-office policies, which should address the same. Health and wellness protections for buildings post-pandemic will typically range from upgrading cleaning protocols and filtration systems to the growing trend in WELL certification — a comprehensive third-party rating system that reflects standards derived from the World Health Organization, U.S. Centers for Disease Control and Prevention, ASTM International, ASHRAE and others. The certification process evaluates how a built space fosters a culture of health and well-being generally as follows:

1. Ensures high levels of indoor air quality throughout a building’s lifetime;
2. Reduces health risks due to contaminated water and excessive moisture;
3. Increases access to healthier food and beverage choices;
4. Promotes exposure to light to create environments that are optimal for visual, mental and biological health;
5. Promotes movement and discourages sedentary behaviour;
6. Promotes human productivity and ensures maximum level of thermal comfort among all building users through improved heating, ventilation and air conditioning (HVAC) system design and control;
7. Bolsters health and well-being through identification and mitigation of acoustical comfort parameters that shape occupant experiences in the built environment;
8. Uses substances that reduce human exposure to hazardous ingredients;
9. Promotes mental health through policy, programme and design strategies;
10. Supports essential healthcare, workplace health promotion and accommodations for new parents.

There is an extraordinary opportunity now and into the near future for companies to use CRE to compete, win the talent war and ensure resilience. Based on our research and observations, the companies who have the foresight and courage to act on these developing trends will likely benefit tremendously from these opportunities.
BEST PRACTICES AND PROTECTIONS TRENDING NOW FOR CRE LEASES

There is no debating the tangible evidence of the workplace impacts caused by the 18-month pandemic period; however, we were curious to see if there were any other behavioural changes in CRE decision making that may be a bit more obscure to identify.

Despite the uncertainty and social/eco-nomic dismantling the pandemic unleashed on the world, commercial real estate has proven again to be the proverbial ‘canary in the cave’ relative to the overall effects of COVID-19. This is no shock, it is simply a reminder that real estate net absorption ultimately reveals the good and bad impacts of our economic world, with the 2020–21 COVID-19 pandemic being no exception. Within this framework, we took a look at what lease data could tell us about current commercial real estate trends and what interesting behaviour could be discovered.

THE DATA

The anonymised data utilised for this article was predominantly sourced through Quarem, a US-based CRE lease management software company headquartered in Texas. The Quarem platform manages thousands of leases across the world and is employed by corporate lessees/occupiers as a lease administration tool to manage at a granular level the myriad lease obligations that come with every lease agreement. The data ranges from typical lease business points such as size, key dates, rent/expense schedules and options to more esoteric issues like indemnification, market reviews, force majeure and subordination. As previously mentioned, the data was anonymised and only included a random sampling consisting exclusively of multinational organisations. For clarity, anonymised data simply means the data was processed to remove or modify any identifiable information to a particular organisation or company.

The lease data was aggregated through a one-year period spanning September 2020 to August 2021. Once the data was collected, it was analysed through the lens of compare/contrast from the prior 12-month period (September 2019–August 2020). We made no attempt to target certain data sets such as rent and size fluctuations, or defaults, but rather took a more high-level approach of simply identifying any measurable lease data that did indeed fluctuate. By looking at this data, we could more accurately identify the reactionary behavioural trends being implemented by global real estate decision makers during the past COVID-19-influenced year.

Trends we see in the data

Shorter lease terms

This was perhaps the most obvious and expected outcome of the entire analysis. If the overall guttural essence of the past 18 months could be condensed into a single word, it could arguably be uncertainty. And to be sure, the data clearly reflected no appetite for committing to long-term lease obligations from corporate occupiers. Seemingly overnight, offices, retail stores, manufacturing and distribution facilities were left virtually empty, yet of course still retaining the burdens of rent and essential upkeep required to avoid deferred maintenance issues. The initial question of when will employees be safe to return gave way to the more ominous concern of would they ever return. The whole concept of the utilisation of commercial space became an open topic and rife with controversy.

Prior to the pandemic, the average term duration of new leases was 68 months (see Figure 1). The average lease term of renewals was 55 months. These averages were reduced to 17 months and 14 months respectively during the 2020–21 review period. Overall, 72 per cent of the leases that were renewed...
or extended were for a term of 13 months or less. Additionally, we saw a mere 3 per cent increase in new lease space commitments, meaning that of all the sampling of leases analysed, there was only a 3 per cent increase (or growth) consisting of brand-new leased locations. This appears to indicate a definitive trend toward putting expansion plans on hold.

The takeaway from this is quite obvious and, as previously mentioned, not at all unexpected. Companies across the globe are rightfully taking their time to re-evaluate the long-term ramifications of the pandemic and strategically engineer their future use of commercial space. The real question is what impact this will have on property valuations that rely heavily on credit-worthy, longer-term lease commitments.

**Force majeure**

This mechanism applies much more to North American leases than other global regions but is nonetheless a metric wherein we have seen movement enough to bear mention.

Force majeure is a concept and legal clause which identifies unforeseeable circumstances preventing either party to a lease (or contract) from fulfilling the obligations of the agreement. In spirit, the purpose of the clause is to provide some degree of relief to the parties of an agreement in the wake of an uncontrollable extraordinary event. In practice, however, most force majeure clauses do not excuse a party's non-performance entirely but only suspend it for the duration of the catastrophic event. To compound the problem, typical force majeure events are isolated to a specific and small area, such as a city or region. Companies can usually absorb the financial impact of a facility hit by an earthquake or a hurricane, but this COVID-19 pandemic has been the equivalent of a global earthquake that struck every region simultaneously. Few corporate occupiers ever considered such a global event and as a result, this provision has gone unnoticed and rarely negotiated for decades, rendering it relatively 'toothless' to provide relief to lessees.

Not surprisingly, we have seen a significant increase in 1) the attention to tracking force majeure clauses, and 2) lease clauses now detailing either some form of obligation relief and/or termination rights.

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**Lease Terms (Duration in Months)**

![Figure 1: Lease terms (duration in months)](image-url)
Let us begin with the increase in tracking this provision at all. Prior to summer 2020, only 32 per cent of Quarem clients requested or insisted that force majeure clauses be abstracted and tracked in the database. Since then (June 2020), 87 per cent of all the leases abstracted now have the clause being tracked in the database. Suddenly force majeure language has become remarkably popular to be tracked and accessible; however, the real shift has come with what is now being included in some of the newer force majeure clauses — the actual ‘teeth’ we spoke of earlier (see Figure 2). We have seen a 22 per cent increase in these clauses that now have either explicitly described rent abatements or outright tenant termination rights after a defined time period.

An example of this can be seen in the following language that was negotiated into a recent lease agreement.

Except for the payment of monies, neither party is in breach of its obligations under this agreement or be liable to the other party for events beyond its reasonable control, including without limitation: acts of God, war, terrorism or threats thereof, fire, hurricane, actual or threatened labor strikes or lockouts, failure or default of public utilities, pandemic, epidemic, viral or communicable disease outbreak, or other public health threats as determined or recognized by the Centers for Disease Control and Prevention, the World Health Organization, or local public health agency, shelter in place or similar orders, governmental actions or advisories, or any other cause beyond the control of the parties that makes it impossible, illegal, limpracticable, or inadvisable from an economic, personal safety or policy basis for either party to properly execute its obligations under this agreement (a “Force Majeure Event”). The party that is unable to perform must take reasonable steps, in good faith and with due diligence, to mitigate the effects of the Force Majeure Event, including, but not limited to reducing expenses. If, after thirty (30) calendar days of delay as a result of a Force Majeure Event, either party is still unable to perform its obligations hereunder, then either party will have the option to terminate this Agreement in writing as though the Term had expired as of the date the Force Majeure Event began.

Unlike the example given, in most instances we have seen where termination rights are granted there is usually a substantial financial penalty for the tenant, which apparently is an acceptable trade-off for defined certainty. Additionally, most of the time provisions are relatively short, such as 30–60 days, but nonetheless this represents a significant shift in both tenant and landlord behaviour since the pandemic.

Like most pendulum swings, tenants will negotiate hard for more defined and
restrictive force majeure language until landlords cease to concede and the pendulum will again move to equilibrium. We think, however, that the days of overlooking or ignoring these clauses are over for the foreseeable future.

**Termination options**
The popularity of termination options to lessees has always been high, while equally opposed by landlords. Today, termination options have moved from popular nice-to-haves to nearly imperative for tenants, especially if a longer-term lease is the landlord's objective. Echoing the current post-pandemic theme of uncertainty, occupiers are increasingly insisting on rights of termination (see Figure 3), and they appear willing to pay for those rights. The data of the last year certainly supports this shift.

Leases executed within the last 12 months and with three years or more in term show a marked increase in associated termination options. Compared to 2019, 56 per cent of the recently completed leases now have tenant termination options. Most are 'for convenience', meaning at the sole discretion of the tenant; however, approximately one-third are tied to financial performance or governmental mandate for lockdowns. Additionally, of those leases with termination rights, 72 per cent have some financial penalty associated. The message once again seems substantiated that the concussion of governmental lockdowns and public fear has resulted in corporate uncertainty. The ripple effect of the last 18 months will likely last for years relative to lessees committing to longer-term real estate obligations. The common denominator is what the long-term effects will be for investment in CRE.

**Renewal options**
There has been no real shift in the frequency and duration of documented renewal options; however, we have seen a slight uptick in leases with predefined rent schedules included in the renewal terms. Traditionally it is quite common to see renewal language simply reference renewal rental rates as 'at market rates', whereas in the past year we are seeing more explicitly defined rates. Our speculation is that this has more to do with the new international lease accounting standards than the ensuing uncertainty brought on by the pandemic.

Generally speaking, the accounting guidelines under both ASC 842 (applicable

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**Figure 3: Increase in tenant termination rights**

<table>
<thead>
<tr>
<th>Year</th>
<th>Termination Rights</th>
</tr>
</thead>
<tbody>
<tr>
<td>2019</td>
<td>19%</td>
</tr>
<tr>
<td>2020</td>
<td>44%</td>
</tr>
<tr>
<td>2021</td>
<td>56%</td>
</tr>
</tbody>
</table>
only to the US) and IFRS 16 require lessees who have a high expectation of exercising a renewal option, to include those rents/expenses into their right of use and subsequent amortisations. When financial terms are not clearly stated in the lease agreement, the tenant must estimate those expenses within a defensible range to perform the required amortisations. If the estimates are off by a material amount (a very subjective standard), the tenant must make adjustments or re-amortise the lease. This poses little trouble for organisations with just a few leases but creates quite a major compliance issue for larger portfolios. We expect to see an increase in renewal options specifying the rental terms in the upcoming years as well as a decrease in the market review practice in markets where that is standard.

**Conditions precedent**

This is a newer evolution of the standard ‘go dark/co-tenancy’ (GD/CT) clause, which is a common provision in retail leases, albeit more prevalent in the US and Western regions than globally. The traditional use of a GD/CT clause ties various lease obligations for one tenant to the active presence of one or more other tenants and can also be tied to the overall occupancy of a property. For example, tenant A is a retailer who depends on the foot or car traffic from a specified tenant B. If tenant B vacates the property or closes, tenant A may have the right to reduce its rent or even terminate. This may also be applied to an entire property. If a dental practice leases space on the ground floor of a large office project, it is likely expecting the daily foot traffic generated by the other tenants to support the business. In this case, the tenant may have a GD/CT clause providing obligation relief if the property drops below 70 per cent.

The conditions precedent is a clause we saw emerge in the last year. Rather than tying lease obligations to a GD/CT or property occupancy, this clause is much broader in scope and can be tied to any number of key performance indicator (KPI) metrics. We have seen it tied to a tenant’s sales revenue threshold, government-mandated lockdowns, and in one case dependent on a daily average of confirmed COVID-19 cases over a 30-day period. There is not enough data to even remotely call this a trend yet; however, it does merit mention. Also worthy of note, in most cases the relief is limited to rental abatements and not termination.

**Trends we see in action**

We now turn our attention to trends we are seeing and hearing from CRE managers. Beginning in December 2020, we began actively polling many of our clients, as well as recording corporate occupier requests. This is certainly a more subjective analysis, but what we are seeing from a lease administration data perspective is nothing short of a monumental shift from anything we have witnessed in over 20 years. Specifically, lease administration practices are going well beyond tracking lease term, rent, options and critical dates; deeper and more extensive data is the new trend.

**Standardisation of acceptable lease terms**

CRE departments are beginning to take real steps to standardise the lease terms that are within their boundary of risk. This applies to both lease business points and legal provisions. They are establishing well-defined checklists of lease structures, clauses and options to mitigate the risk exposure many companies experienced in 2020 when the pandemic hit. The common practice of allowing lease negotiations to be conducted by local company leadership and governed purely by business/legal nuances native to a particular region or real estate market proved to be problematic and expensive. We are seeing a structured shift toward standardisation from companies throughout the world.

It is important to note that corporate
standardisation of lease terms is really more about incorporating lease provisions that proved to be most beneficial in a world crisis, not just reduce risk. Put another way, these are about establishing and actually putting into action best practices for lease obligations. It makes very little sense for an organisation to have well-placed, strategically sound lease provisions that offer maximum flexibility in times of crisis or fluctuation in only a few leases/locations, while simultaneously leaving other leases vulnerable due to corporate communication gaps. Best practices are based on measurable performance indicators; the knowledge of these proven practices need to be shared throughout companies with global real estate. The 2020 COVID-19 pandemic was simply the catalyst for this shift moving.

**Emphasis on reliable lease data**
In early March 2020, our company, Quarem, was facing the same perilous uncertainty as every organisation on earth. The thought kept coming to mind: ‘Who in their right mind is going to be concerned with their lease data when the whole world is melting from the fear of sickness and death?’ Apparently, quite a few.

By mid-March 2020, the floodgates opened. We received calls, e-mails, web messages and even texts from corporate clients desperate to get reports on their options for rent abatements, lease terminations, force majeure, GD provisions, landlord default or anything that would offer financial relief without creating a lessee default event. In most cases, these companies did not even know who to contact for their various leases. They simply overlooked the need to update and maintain the names and contact information of their property managers and landlords.

The reality was clear: most of the lease data global companies track is either incorrect or missing altogether. As of August 2021, 61 per cent of our existing clients and 94 per cent of our new clients have either requested thorough desk-audits of their lease data or completely new lease abstracts of their entire portfolio. The interesting aspect of this is the depth of the abstraction requested. Prior to the pandemic, it was very common for our clients to request what we call ‘lite’ abstracts in an effort to control what was at the time considered unnecessary expense. These typically cover only the basic business terms and lease clauses. Today we see a complete 180-degree shift away from lite abstracts but rather to deep, thorough, almost forensic-level abstracts. Data is captured on nearly all aspects of the agreement, both business and legal, and the clauses are catalogued for portfolio-wide search and reporting. Additionally, many companies are making an annual practice to survey landlords and property managers for up-to-date contact information. The key observation is that organisations with global real estate are realising that most of their lease data was unreliable, and a good number (at least from our vantage point) are taking steps to make it dependable and actionable.

**Benchmarking/KPIs**
There has been a recent move toward utilising KPIs to establish benchmarks to grade or rate leased facilities. Historically most leases were simply measured against market rental rates in an effort to assure the company was not paying above-market rent. Today we are seeing a broader use of KPIs to measure lease performance that go way beyond location and rent. Companies are beginning to look at productivity output, sales growth/declines, staffing/recruitment, environmental impact, logistics, demographics and costs that include both hard costs and soft costs. These KPIs are scored for each location and compared to the other locations. The leased facilities that rank the highest are the new benchmarks by which every other location is measured. We have also seen some organisations employ
a practice whereby internal representatives from various departments (such as sales, marketing, finance, HR, operations, etc.) each independently score new locations that are being considered to determine the best facility to lease.

This represents a significant evolution in the practice of lease administration, as it tangibly aligns the real estate with the corporate strategy. The actual number of companies we have seen begin to apply KPIs and benchmarks to their lease portfolio is still relatively small, but nonetheless is still intriguing, since nearly all have expressed interest within the pandemic year.

CONCLUSION

It is certainly no secret that the pandemic and related events of the past 18 months have affected and likely permanently changed the use of commercial real estate. The high-density, open concept trend of the last 30 years that placed more people in less and less space came to an abrupt halt. The work-from-home movement gained immediate legitimacy. Companies are scrambling to figure out exactly how their real estate will be utilised and by whom. Staffing and recruitment has become more competitive than ever before. Lease terms are getting shorter or with more termination rights. Sanitary working conditions are now essential. To be sure, there has been a lot of change in a short period of time and requisite uncertainty is still lingering.

With any sudden change or market correction, however, opportunity is presented. Most of the companies we work with are adapting rapidly and showing incredible resiliency. The trends we have seen are simultaneously expected, extraordinary and frankly healthy. We will continue to monitor the data but based on the results we have seen thus far, companies with lease portfolios are reacting through innovation and turning back to the importance of strategic lease management.

REFERENCE