

The New Test of Credit: Did the Tenant Pay During COVID-19?

Dear Clients & Colleagues -

As the commercial real estate investment community navigates its tenuous path through the pandemic, sometimes we are offered fleeting insights into what a post-pandemic CRE marketplace may look like; and more critically, how it may think.

The CRE world in years past has often created convenient buzz-phrases for asserting an investment's resilience or insulation from broadly perceived structural shifts in the broader economic landscape. One easily recalls buzz-phrases such as "Internet Resistant" (i.e., isn't going to be crushed by Amazon), "Hyper-Core" (sexier description for trophy real estate), "Urban Infill" (dense location with perceived barriers to competition), "Mission-Critical" (the tenant can't leave, because...), "Investment Grade" (so much capital they'll never stop paying you and have been rated as such) and the list goes on. Whether these monikers were speaking truthfully about the real estate is another discussion, but they became so commonplace that perception in many instances became a reality.

While the buzz-phrase of the day is "Essential Retail," an undercurrent dynamic is beginning to manifest itself, which may erode this buzz-phrase's reception amongst investors. We have argued over the past few months that the CRE landscape is becoming "[Trifurcated](#);" tenants fall in the Essential, Impacted, or Obliterated categories. Essential tenants clearly are understood to be in a position not to need support, while Impacted tenants can make a case for support, and Obliterated tenants may not even survive even if support were offered to them.

Of late, we have begun to see some tenants who fall into the Essential category now ask for rent concessions of different variations. In recent weeks, Sherwin-Williams sent all its landlords a letter asking for rent to be reduced by 30% for the balance of 2020. While marketplace thinking is homogenous, most participants would have viewed Sherwin as reasonably able to weather the storm by their financial position and needs-based retail model. However, that did not stop them from making the request, nonetheless. We can also point to Starbucks, who recently started to seek steep rent relief from its [landlords](#). Pre-COVID Starbucks was (and continues to be) a leader of the coffee segment and in a stout financial position. They were a tenant that was viewed as a staple that could survive even challenging economic conditions. This has enflamed the emotions of landlords, as many of them have seen or have borne the lines leading to Starbucks drive-throughs, which often exceed 30 minutes. There is an economic disconnect between the perception and reality of Starbucks' financial challenges, but such dynamics are certainly shaping the collective thinking of the market regardless.

On the other side of COVID-19, it is possible that a new moniker of strength is forming that will have far-reaching consequences. The ultimate litmus test of a tenant's strength, mindset, and partnership may well become "Did they pay rent during COVID-19?"

While on the forefront, it may seem like an innocuous question, it may shape many market forces in the years ahead. Looking to one simple example, consider how rents on newly developed Starbucks are determined. For build-to-suit locations, a developer prepares a total budget for the costs to build a new Starbucks. The developer then quotes to the tenant a yield (a percentage) against the overall budget, arriving at the rental rate for the location. The development yield is a byproduct of the spread between a projected exit cap rate and the budgeted yield on cost, which in years past has ranged from 150-200bps. The developer is solving a risk/reward calculation. If investors purchasing the product on the back-end react to Starbucks rent concession requests by pushing cap rates up by 50 basis points, then development yields will rise by a commensurate level, causing a wholesale increase in prevailing rents for Starbucks as the risk for building Starbucks a building has not changed, and if anything it's now perceived as "riskier" because of the potential for further fluctuation on that "exit cap rate."

This impact is likely not only confined to new construction assets (something that Starbucks might calculate is worth the cost) but could surface in lease renewal discussions. Pre-COVID, a landlord might have been predisposed to offer Starbucks a 15-20% rent discount to remain in place for another 10 years. That thinking may very well shift Post-COVID, as landlords calculate that they are better served to not acquiesce to the request to make up for past concessions, or shelter against future requests.

If Starbucks sees their Gross National Rents increase by 5-10% nationally over the next decade because of these dynamics, then the rent concessions they achieve over the next 12-18 months may very well have been short-sighted. Only time will tell if "Did the Tenant Pay During COVID-19" becomes the new market litmus test for CRE tenants.

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