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“Location, location, location” replaced by “COVID, COVID, COVID”

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The fairly robust performance of the Canadian real estate market in 2019 continued into 2020 … and then the COVID-19 pandemic hit. COVID-19 impacted each sector of the real estate market differently, each for different reasons. While retail real estate was severely and detrimentally affected, industrial real estate appears relatively unscathed. The jury is still out regarding the effect of COVID-19 on the office sector.

Retail real estate

Hardest hit was the retail sector. Retail real estate was already showing signs of softening before the arrival of COVID-19 due to a slowing of new entrants into the Canadian market and a continuing migration by shoppers to e-commerce. COVID-19 dramatically and almost instantly hurt the retail real estate sector, as governments ordered retail centres across Canada to close in March. Some provinces allowed them to re-open in May, others not until July. These closures had a number of significant and immediate impacts:

- Tenants immediately looked for rent relief to offset the sudden termination of their revenue. They soon learned that “business interruption insurance” likely would not apply, that their leases were not terminable for frustration and that even if the COVID-19 pandemic was an event of *force majeure*, their leases might still require that rent be paid regardless of the economic hardship they were experiencing. Litigation has started to make its way through the courts around rent obligations, as discussed below.
- Landlords initially demanded that rent be paid in accordance with the lease terms. However, once the tsunami of rent relief requests and rent defaults arrived, and the magnitude of disruption in the retail industry became clear, landlords changed their collective minds and short-term rent deferral agreements became the norm.
- The Canadian government was initially slow to act, but eventually implemented the Canadian Emergency Commercial Rent Assistance program (CECRA), which was met with fairly poor reviews. CECRA provided targeted assistance only to small to medium sized tenants who had lost at least 70% of their revenue due to COVID-19. The program required a landlord to voluntarily apply for a forgivable loan of up to 50% of the gross rent owed by the tenant for the period in question (initially March to July, which was subsequently

extended to September). CERCA also required the tenant to pay 25% of the gross rent owing and the landlord had to forgive 25% of the gross rent for that same period. Accordingly, take-up of this cumbersome program was slow, although it did eventually gain traction. In October, the government announced the Canadian Emergency Rent Subsidy program (CERS) to replace CECRA. Unfortunately, few details of this new rent relief program were available at the time of writing.

- While the above measures alleviated some of the negative impacts of the COVID-19 pandemic, a significant number of retail tenants were nevertheless forced to seek relief by filing under the *Companies' Creditors Arrangement Act* (CCAA) or the *Bankruptcy and Insolvency Act* (BIA). Through these processes, tenants sought to either disclaim some or all of their leases or to renegotiate their rent (or both), while landlords negotiated to keep as many stores open as possible to save their retail real estate.
- Against this backdrop, consumers who had been prevented from shopping in person due to closures simply flocked to e-commerce. This significantly accelerated the migration away from bricks and mortar retail and further exacerbated the negative impacts of the COVID-19 pandemic on retail real estate.

Finally, in the retail arena we are starting to see some legal implications for commercial leasing arising from the COVID-19 pandemic. A recent decision in Québec held that the tenant under a commercial lease was entitled to rent relief, not because of *force majeure* and not because of any contractual remedy in its lease. Instead, the Court held that the landlord had breached the covenant of quiet enjoyment because the tenant had been unable to access the premises due to the government-ordered closures. This decision is now under appeal. See our our Osler Update entitled "COVID-19 pandemic: A first perspective from the Québec Courts discussing the availability of the *force majeure* defence in a real estate context" on osler.com.

Similarly, certain tenants have filed proceedings against their landlords, alleging that their retail properties were not managed in a "first-class" manner that would make retail customers feel comfortable shopping in person notwithstanding the COVID pandemic. These tenants argue that such measures would have prevented in-person sales from falling as dramatically as they did.

Despite these setbacks, most major retail centres in Canada remain owned by large pension funds, public REITS or other well-funded and well-run entities. Accordingly, our expectation is that most of these centres will survive and will simply implement improvements that they were likely already planning, but at a faster rate. Watch for more amenities to be added (e.g., restaurants, medical offices, co-working space and gyms) and perhaps also new residential components, all in an effort to maintain a customer base for their retail tenants.

Industrial real estate

At the opposite end of the spectrum, industrial real estate seems to have been relatively unscathed by the COVID-19 pandemic. Availability rates continued to decline over the course of 2020 and, correspondingly, rental rates continued to climb. In fact, COVID-19 may have improved the demand for industrial space:

- The accelerated shift to e-commerce has increased demand for warehouse space for retailers and logistics providers, especially in and near urban centres.

- Supply chain logistics have also been affected as 30-day “just in time” inventory levels are being replaced by 90-day “just in case” inventory levels in response to panic buying behaviour that occurred early on in the pandemic. This has further increased demand for warehouse space.

Office sector

COVID-19’s impact on the office sector is harder to discern. It appears that the overwhelming majority of office workers have been able to adapt to “work from home,” so there has been less immediate negative impact to office tenants and therefore the office sector. Unlike the retail sector, we have not seen widespread desperate pleas for rent relief from office tenants or widespread rent assistance agreements from office landlords. To date there have not been any rent relief programs from government for the office sector. However, the impacts on this sector may simply be delayed. Vacancy rates prior to the pandemic were at historical lows in most urban centres in Canada, with the exception of Calgary, and large blocks of office space were increasingly difficult to find. However, this is now changing.

- Vacancy rates have more than doubled during the COVID-19 pandemic, both for direct leased space and also sublet space, in less than eight months.
- The climbing vacancy rate in the sublet market is clearly an indication that a growing number of office tenants are downsizing. It is unclear whether this is because their business is suffering or because they realize that they can shrink their office footprint by implementing and continuing to promote a work-from-home policy.
- The COVID-19 pandemic has also led to the idea that having multiple smaller satellite offices (the “hub and spoke” concept) may be a safer model. This model allows groups of employees to drive to different local offices, which appears less risky than having an entire workforce travel, presumably mostly by public transit, to one major office every day, which presents greater risks of potential exposure to COVID-19.

If vacancy rates continue to rise, this could eventually pressure rental rates to fall. However, a continued growth of population in urban centres and perhaps a move to more social distancing/decreased density in offices could offset these negative impacts.

Transacting in real estate

COVID-19 also had immediate impacts on completing transactions as well as the types of transactions pursued. Early in the pandemic, transaction flow quickly slowed before eventually returning to normal levels. Many borrowers initially drew down on their operating credit lines to ensure they had enough liquidity. Similarly, we saw more clients arranging both additional secured and unsecured loan facilities to increase available cash.

COVID-19 also presented unique challenges in actually closing transactions. In certain asset classes (e.g., retirement homes and multi-residential properties), property tours were either prohibited or significantly limited, thereby greatly upsetting usual diligence practices. Several deals simply could not proceed until the purchaser or lender could physically attend and inspect the property. Accordingly, it became common to extend diligence periods to the extent COVID-19 limited the buyer’s ability to conduct normal diligence. And of course, foreign buyers were also required to negotiate their way through border restrictions and required 14-day quarantine periods before being able to tour a property.

Due to backlogs and a reduced workforce delaying the issuance of CMHC-insured financing and other loans, we also saw an increase in bridge financings and vendor take-back financing being required to close transactions.

On a positive note, we learned that even very complicated multi-property deals spanning multiple jurisdictions, involving multiple vendors and multiple lenders with several law firms, could be successfully completed on a remote basis. Never has an investment in good technology been more critical.

This has been an interesting year in the commercial real estate industry and the impacts of COVID-19 are likely to reverberate for some time.