COVID-19 Considerations for Leased Real Estate
Understanding and assessing impacts

The Issue
With the rapid global spread of COVID-19, both landlords and tenants have felt an impact as many businesses make the decision, or are required by law, to shut down offices, stores, and restaurants in hopes of protecting the public, their employees, and their patrons. Given that leased real estate expenditures are frequently a material operational expenditure for many businesses, uncertainty regarding leased real estate is on the minds of many businesses as the impacts of the pandemic expands.

Practical considerations
During these unprecedented times, business leaders are being forced to make decisions regarding the operations of their organization, contemplating challenging business scenarios, as well as the perspective of the betterment of societal interest. While this is uncharted territory for most parties, it remains uncertain how the decisions made today will impact the weeks and months to come.

Specific to leased real estate, organizations should consider focusing on and understanding their contractual rights and obligations by reviewing their lease contracts for specific covenants and clauses that may contain valuable information regarding the implications behind property closures and operational changes. Some examples and descriptions of their general nature and purpose include:

- **Force Majeure**: may excuse parties from lease obligations in the case of events that neither party could control (e.g., natural disaster, war, riot, “act of God”)
- **Continuous operation**: may require a tenant to operate its business continuously throughout the lease term in the premises
- **Hours of operation**: may require a tenant to operate its business during defined business hours, with defined exceptions (e.g., holidays)
- **Co-tenancy**: may allow a tenant to reduce rental amounts if certain tenants leave the premises
- **Go-dark**: may grant a tenant rights to discontinue operations, frequently while continuing to pay rent
- **Default**: may identify where the failure of certain terms and conditions by either the lessee or lessor will nullify specific rights and provisions of the opposite party

Potential action steps

**Identify lease rights and obligations**
- Use natural language processing lease abstraction technology or similar technology accelerators to efficiently identify specific lease provisions, pulling the clause text to the forefront for analysis
- Review lease clauses from both the contractual perspective based on the terms defined in the lease, and from the human perspective, focusing on the unity of society in response to the extraordinary circumstances

**Assess, model, and strategize**
- Document and record events between the parties of the lease
- Create a lease mitigation matrix or scorecard to help the organization strategically assess the strength and remedying options of leases for action or risk
- Analyze and model the potential impact of property closures, concessions, and other lease events and/or assumptions
- Perform cash flow modeling and scenario analysis to address financial pressure points at operating and portfolio companies (especially when liquidity concerns are present)
- Consider the impacts on capital projects and seek to understand the obligations of these projects under the terms of the leases

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Additional considerations for lessees

**Lease accounting treatment for rent concessions**
Rent concessions agreed to by lessees will have to be evaluated to determine the proper accounting treatment under the new standards. If determined to be a modification, then the lease liability for lessees will have to be recomputed using the IBR as of the modification.

**Right of Use Asset Impairments**
Under the new lease accounting standards, lessees are required to record a right-of-use (ROU) asset on their balance sheets for most leased real estate. With COVID-19 likely to quickly impact certain real estate asset values, organizations will need to monitor the fluctuating values of their leased real estate assets and be cognizant of potential impairments occurring when the fair value of the asset reduces to an amount below net book value, requiring the recognition of a loss. In connection with these implications, lessees should be prepared to address various valuation considerations, including:

- **Market rent vs contract rent**: contract rents may be above prevailing market rents
- **Market participant discount rate**: discount rate used to measure the fair value of the ROU asset may be different than the lessee’s Incremental Borrowing Rate (IBR)
- **Abandonment and sublease elections**: valuation assumptions may be influenced by lessee’s election to abandon or sublease space
- **Lease modifications**: may trigger lease reclassification
- **IBR**: lessees’ borrowing cost for new, remeasured, or modified leases may change significantly requiring reassessment

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