



Searching for Solid Ground in Commercial Real Estate

Uncertainty and doubt—two words no one likes to hear. Over the course of the last few years, the commercial real estate sector has seen its ups and downs, depending on the industry. In this article, we break down the current shape of commercial real estate and ponders the question—what comes next?

As we approach the two-year mark of the pandemic, it's clear that overall, businesses around the world have suffered severe impacts. What's intriguing, though, is the differential effect it has had by sector, with some sectors experiencing collapse from restrictions and lockdowns, and others have prospered on buoyant demand. However, nowhere has the disparity been more pronounced than in the commercial real estate sector, perhaps because it shares the fortunes and mishaps of the diverse industries it houses. A review of the main subsectors is illuminating.

Office

In-person attendance at the office went to practically zero starting in March 2020. And workers who proved their worth in a virtual world gained an expectation they could remain at home even as the pandemic shifts. Companies are now grappling with what space they need, and where to locate it. Considerations include more enclosed offices to replace open floor plans; “hotelification” and space-sharing arrangements to optimize use; and modified floor plans designed for team-based work. Traditional “HQ” buildings won't go away, but their role will be impacted as firms explore other models.

Retail

Many retailers were impacted by government-ordered closures and others suffered the hesitancy of customers to leave home to shop. Even within retail subsectors, some big-box retailers were permitted to stay open while small competitors were shut down. Clearly, the pandemic has accelerated digital trends toward online shopping and e-commerce. For some, Winners, HomeSense, Value Village and other off-price brick and mortar retailers may live on for all those treasure-hunt customers. However, the shift to online is likely to continue in the long-term.

Food Service

The worst property victims have been restaurants, with dine-in options either eradicated or limited for extended periods. Curbside pickup, take-out and home delivery services and reliance on [ghost kitchens](#) all blunted the blow. But the sheer length of the closures rendered many foodservice entities insolvent. The court-monitored restructuring of [Mark McEwan's](#) locations has followed a string of creditor protection and insolvency filings by restaurants in Canada and the U.S. And [Restaurants Canada](#) reported in the summer of 2021 that eight of 10 restaurants were losing money.

Industrial

Industrial real estate has fared well overall, but again it depends on the industry. The pandemic-driven online shopping trend has bolstered demand for quick and cheap delivery with the result that industrial warehouses and logistics centers have gained value as investors snapped up buildings essential to the delivery economy. Avison-Young reports that average net rental rates among industrial properties in the Greater Toronto Area (GTA) are soaring as the available square footage shrinks.

Who Knew?

It's easy to say the pandemic effects on commercial real estate were largely predictable. But no one knew how long the pandemic would last, how many hundreds of billions that the federal and provincial governments would fund to address it, or how employees, customers, and suppliers would respond. Many Real Estate Investment Trusts hit bottom *before* the March 2020 lockdowns and then rose steadily through each successive wave and against a constant daily barrage of bad news.

What's to Come?

A lot more uncertainty and disruption. Going forward, we don't yet know the effects of removing CERS and CEWS supports, which are set to end as this article is being written. These emergency rent and wage subsidy programs have propped up some companies or delayed the crunch for others. Now, the clock is ticking.

Where rents have been deferred by landlords, there are limits to such relief, and financial consequences when time runs out. How will spending patterns change for dining out, and home delivery of all things consumed? And what is the demand equation for office space? Will workers relocate back to the cities? Will (or can) employers insist on returning to HQ?

All in all, a lot of businesses will return with more debt than pre-pandemic times, and this is likely to result in higher vacancies, changing needs, and fallout of tenants due to financial distress. It's hard to say whether these factors it will translate into more insolvency filings for property owners and landlords, but a reckoning is at hand for many.

A circular reference in all this that one hates to contemplate. Real estate represents such a significant part of the Canadian

economy that an appreciable decline would reverberate to mortgage lenders, banks, the workforce and municipalities that depend on local levies, with further knock-on effects. Property values in the residential market have seen an extraordinary increase. And if incipient inflation continues to take hold, the Bank of Canada may have no choice but to respond with higher interest rates—the showstopper for all things real estate related and maybe the pin to pop the residential increase bubble. More unpredictability.

What to Do?

There are some basic takeaways for investors in commercial real estate, though most come down to diversifying, maintaining flexibility, and remaining cautious. Diversification could be by property, type, location or by tenant make up. Consider, for example, whether property investments can undergo a change in use or zoning from office to residential. And mortgage debt must be at a level and of a term that can weather an increase in interest rates if inflation returns.

It's been a bumpy ride through the pandemic, but the search for solid ground in commercial real estate isn't likely to get easier any time soon.

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