<u>ULI Washington Retail Roundtable</u>

COVID-19's Impact on the Regional Restaurant Industry: Landlord, Tenant and Lender Perspectives

July 2020

The Retail Situation

In the real estate industry, there are a variety of stakeholders that include: Lenders, Equity Partners, Owners, Tenants and Customers (who may be the Tenant as well). COVID has created unparalleled disruption across the entire ecosystem of real estate, none more immediately apparent than in the retail sector where many businesses were forced to close their doors for months without alternative sources of income. Unlike other recessions, the global event precipitating this downturn arrived without warning and was impossible to forecast or prepare for. While some regions have begun to slowly reopen, continuing public health concerns and restrictions will impact operations and sales for many more months if not years. It is unlikely that the retail sector will ever return to business as usual, even after consumers feel safe in a social setting. It is likely that closures and disruptions will have lasting changes on the retail industry in ways we cannot predict today.

On July 8th ULI Washington brought together a variety of stakeholders – focused particularly on the food & beverage industry – to discuss the perspectives and constraints each group is facing as well as help move forward with solutions. This report largely focuses on the impact on the restaurant industry and potential solutions for the future, however it should be recognized that these same economic shocks are being felt across all retail businesses particularly the entertainment, fitness and service industries.

Over the course of the last ten years, the real estate industry has shifted merchandising such that restaurants now serve as the anchors for many retail centers whether in urban commercial corridors or suburban shopping centers. Food is a form of social engagement and attracts visitors as much as creates an identity for neighborhoods and cities alike. Restaurants (quick serve and full service) now represent nearly 25%-40% of the square footage of many shopping centers (up from 10-15% a decade ago) and are one of the primary forces of vibrancy on city streets. The restaurant industry is one of the largest economic engines in the US, employing an estimated 1 in 10 people (15.6M) with 51% of the total food dollar (including grocery and restaurants) going to the restaurant industry[1]. The restaurant industry is one of the most entrepreneurial and diverse sectors with an estimated 500,000 independent restaurants (50% of all locations) nationally of which 76% employ a large number of women and minorities. In March 2020, COVID-19 swept across the US impacting nearly 6M restaurant jobs with an estimated 60-70% of all revenues vanishing[2].

The saying is "where this is no risk, there is no reward," and the restaurant industry remains one of the riskiest ventures. It is the most expensive category of retail to build because of venting, equipment, design, and sometimes limited ability to repurpose second-generation space. Build-out over a cold dark shell delivery for a typical quick serve restaurant costs $650,000 (assuming 2,500 square feet) and full-service restaurant costs $1.5M (assuming 5,000 square feet). Operating margins are low-- typically only 8-10%. With already tight margins, government closure mandates and phased openings with occupancy limitations have severely impacted operators. Quick serve restaurants have been able to continue operating with minimal changes in the COVID environment, albeit with reduced sales, but nearly all full

[1] National Restaurant Association ; https://restaurant.org/downloads/pdfs/research/soi/2020-state-of-the-industry-factbook.pdf

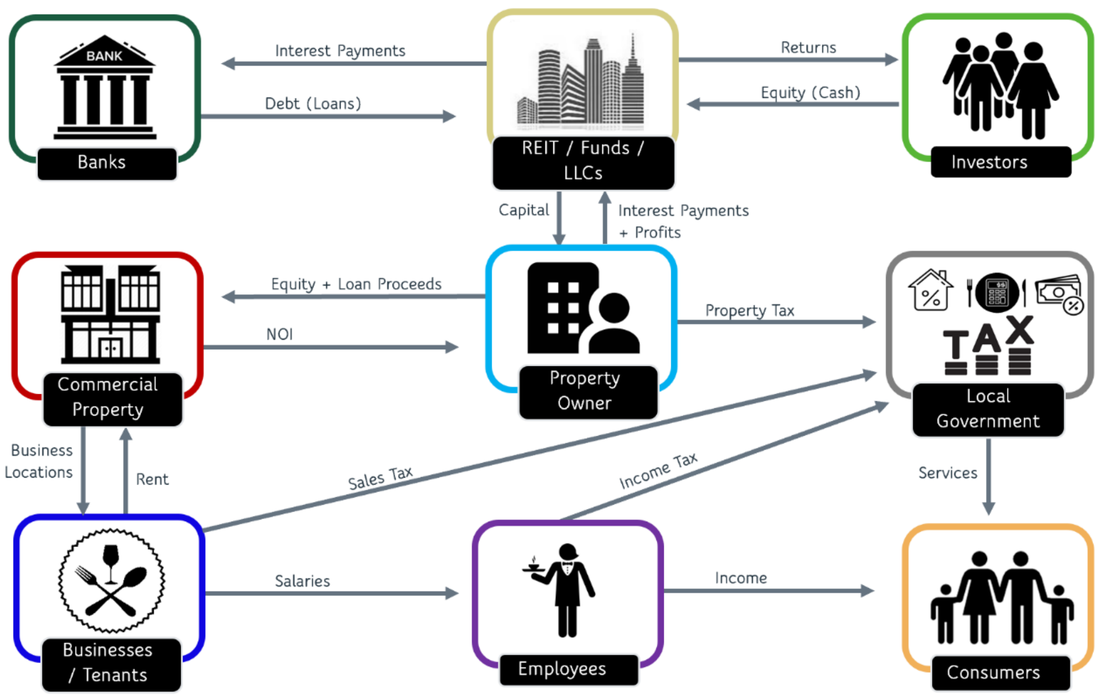
[2] Independent Restaurant Coalition; https://media-cdn.getbento.com/accounts/cf190ba55959ba5052ae23ba6d98e6de/media/EmH1JsVMRNylmKAeF2FJ_Report.pdf

service restaurants were shuttered as they had to revamp menus, create to-go options and shift what, where and how they could serve customers.

The mass closure of consumer-facing businesses, many with already limited operating-cash flow, has created a large trickle-down effect along the real estate ecosystem that is potentially devastating to our entire economy.

The Stakeholders:

Below is a depiction of the high-level ecosystem involved in the retail real estate industry, focused on restauranteurs[3].



Landlords / Owners:

Structure

Landlords purchase real estate properties with a combination of debt and equity. Typically, the debt (30-70% of total property value) comes from banks, either at the asset level or at the company level. The lender receives monthly debt payments from the owner who agrees to put up the property as collateral in the event of non-payment and agrees to maintain various debt covenants, such as maintaining a minimum income level to ensure cash flow will be available for payment. Equity investors – often pension funds, institutional investors, or high net worth individuals – contribute 20-70% of the property value in exchange for a return on the investment, usually 5-10%. The Landlord's revenue

[3] Adopted from: https://medium.com/@tombarrackjr/preventing-covid-19-from-infecting-the-commercial-mortgage-market-e7444701745e

comes from renting spaces to retail tenants such as grocery stores, fitness operators, restaurants, and service providers.

Collections

During COVID, as consumers were mandated to stay home and businesses were unable to generate sales, tenants could not pay landlords in full. Property owners with grocery and essential services saw higher levels of rent collection (65-75%) while street / mixed-use properties were significantly lower at 45-55% of collections. According to an institutional owner/operator, collection rates were higher from independent tenants who were able to access the PPP loan program and were invested in their individual businesses, while many national "credit" tenants have turned their focus to pivoting operations and shuttering their retail locations. Over 75% of retailers have been able to operate in some capacity, but with much reduced profitability from decreased sales volumes and increased operational costs.

Expenses

Landlords rely on the rental revenue to cover fixed costs (property maintenance, utilities, taxes and insurance), variable costs (labor, capital improvements), and debt/equity payments. Usually the smallest portion of the Landlord expenses are common area maintenance that pertain to curb appeal, safety and attractiveness of the property. With revenues cut by 25% or more due to vacancies or decreased rent collections, this means the landlord is struggling to pay their expenses and has limited ability to abate and/or defer tenant rental income.

Landlords that are *individual owners* with mortgage/debt have slightly more flexibility in negotiating rents, but ultimately, they face foreclosure if they are unable to pay mortgage payments over time. *Institutional owners* without property level debt are trying to establish nationwide strategies and often have less flexibility in decision making. Additionally, institutional owners often face debt covenant issues at the corporate level that constrain their ability to adjust rent streams at each property.

Deal structures (Pre-COVID)

Restaurants are one of the costliest spaces you can build out in properties. As such, restauranteurs typically ask for large capital investment also known as tenant improvement allowances. Landlords use guarantees to help mitigate landlord risk in making an investment in the tenant improvements. The guarantee (similar to collateral for a lender) is often a personal (typical for Independent businesses) or corporate-level (using corporate balance sheets) promise that the tenant will pay the agreed upon rental stream ensuring the landlord can recoup build-out costs in the event of a business failure. Landlords may consider reducing a guarantee if the tenant has fully built out space or minimal tenant improvement dollars are invested. Likewise, the guaranty may be reduced year-by-year if the tenant remains current in its obligations.

Today, the most common lease structure with restaurants is a fixed rent and a percentage of sales above natural break point. Landlords are often not allowed to be direct investors in restaurant operations due to REIT rules and co-mingling of business interests. As such, the percentage structure provides landlords with nominal upside, but allows restauranteurs to establish a lower fixed rent. Amid COVID, a high fixed rent is nearly impossible for restaurants to fulfill with uncertainty on sales volumes, unknown customer return, and recurring government mandated closures. Yet, since most financing takes only fixed rent into account or discounts percentage rent significantly, a minimum fixed rent is important from the Landlord's perspective. Here we have a divergence of interests between the Landlord and Tenant rent structure that will be challenging to bridge.

Restaurants

Food often serves as the backbone of a community, bringing together all socioeconomic groups in one setting. Local/regional restaurants are sought out by landlords for their "sex appeal", differentiation, and ability to generate value in other elements of the building (office, multifamily, lodging), particularly in mixed-use settings.

Structure

Restauranteurs are generally comprised of three groups: national concepts/conglomerates, regional brands and local, small businesses. Like landlords, they generally have debt (restaurant equipment loans, inventory loans or line of credit, capital loans, SBA loans, and bank loans) and equity partners (high net worth individuals, angel investors, private/venture equity, personal capital). There are over one million restaurant locations in the U.S., and most are small businesses. Nine out of ten restaurants have fewer than 50 employees and 70% of these are single-unit operations[4].

Capital is often one of the most critical and hardest components for restauranteurs to source, particularly due to high failure rates where even during periods of economic growth, approximately 50% of restaurants go out of business within 5 years[5]. One regional panelist noted that although they are a large restaurant group, because each location is unique (not multiple units of the same concept) they do not have the economies of scale and larger buying power that benefit national chains. Additionally, funding and access to capital for regional restaurant groups is similar to independent restaurants.

The restaurant industry has large variable costs and thin margins. Typically, labor represents the largest component of costs fluctuating between 40-60%, the cost of goods sold represents ~3% of expenses; supplies, utilities and marketing is ~15%, and occupancy costs (aka rent) is 7-15%. This leaves 0-10% of revenues as profit. What should be noted is that labor is often considered a variable cost, but in reality, there are a minimum number of workers required to keep a restaurant in operation (e.g. the chef, wait staff, dishwashers). One panelist stated that right now, with COVID, "every square foot of front of house space is a huge liability – not an asset – because of the inability to activate the spaces with in-house dining." While quick serve concepts have smaller footprints and could quickly pivot, full-service restaurants laid off all hourly staff. During COVID, despite limited or non-existent sales, many restauranteurs are paying rent so as not to lose an asset (their built-out space) or avoid being called on their personal guarantee. This negative cash flow is hardly sustainable, "Restaurant analysts and

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[4] National Restaurant Association; https://restaurant.org/research/restaurant-statistics/restaurant-industry-facts-at-a-glance

[5] National Business Capital & Services / 2019 Small Business Failure Rate: Startup Statistics by Industry ; https://www.national.biz/2019-small-business-failure-rate-startup-statistics-industry/

operators have been quoting an estimate that 75 percent of the independent restaurants that have been closed to protect Americans from the coronavirus won't make it."[6]

Deal Structures (Post-COVID)

Panelists agreed that many national chains – with access to capital and buying power – will survive COVID and in fact grow coming out of the pandemic by taking advantage of distressed second-generation restaurant locations. "Without massive changes to lease structures, independent businesses will close." Smaller entrepreneurs believe that landlords are operating under the assumption that COVID will be gone in 3-6 months, but the reality is restaurateurs are not confident they can hang on while paying full rent. "It is like landlords and restaurants are operating in different worlds." Particularly of impact during COVID might be the restaurant owners of color, immigrants and women who historically have struggled to access capital and are closing at a faster rate[7].

Acknowledging limited sales and ongoing business concerns, many landlords are currently offering a range of abatement or deferred rent terms. The deferral terms require payback during some portion of the remaining lease term, some coming as soon as 2021. One restauranteur noted this was delusional and simply delaying the pending "apocalypse." Other landlords have offered to extend lease terms by the numbers of months that rent was not paid, which could be a more palatable option for restauranteurs.

Restaurants need landlords to be their partners and understand the impact closures have had on their sales (e.g. no sporting events, office occupancy near zero, no hotel activity). They are looking for a way to restructure leases, including their guarantees. Landlords are incentivized to create vibrancy in their real estate holdings to attract other tenant leasing across all asset classes (residential, office, retail and hospitality). Successful partnerships with talented restaurant operators can be a path to creating this sense of place, but with limited risk tolerance and capital required.

Lenders

Lenders play a unique role in the retail real estate industry having a relationship with property owners as well as merchants, including restauranteurs. The capital stack for either group varies widely depending on the individual transaction.

For properties, the mix of revenue coming from retail and the level of debt service the property must pay will determine how much flexibility the landlord can offer from a rent or deal structure perspective. If the property has a small amount of retail/restaurant revenue, and its other tenants have been able to operate or pay rent normally, the landlord or borrower has more flexibility or diversity of cash flow to accommodate rent abatement. If the property is a single-use building, full-service restaurant that is now closed or has minimal revenue generation, there would be much less flexibility.

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[6] New York Times, "Independent Restaurants Brace for the Unknown" March 20, 2020; https://www.nytimes.com/2020/03/20/dining/local-restaurants-coronavirus.html
[7] New York Times, "Coronavirus Is Hitting Black Business Owners Hardest" June 18, 2020; https://www.nytimes.com/interactive/2020/06/18/us/coronavirus-black-owned-small-business.html

Flexibility really comes down to how much pain can be shared. At the end of the day, the lender does not want a troubled debt restructuring.

Lender Relief

As part of COVID-19 relief measures, the Fed is allowing lenders to provide up to 6 months (180 days) in short-term modifications for payment deferrals, fee waivers, extension of repayment terms, or other delays in payment without making lenders categorize these loans as troubled debt restructurings (TDRs).[8] If the deferment goes over 180 days the loan may need to be classified as nonperforming which would begin having large impacts on banks' balance sheet and ability to lend. Understanding this is important in providing lenders and landlords relief in lease structures. Some banks offered lenders the entire 180 days while others only granted requests for 90 days. The main issue seems to be what will happen after the 6-month grace period, particularly if occupancy limitations or shutdowns remain in place.

One panelist noted that "lenders are often sandwiched between doing the right thing, minimizing risk and protecting their balance sheets." As more troubled loans come in, they have established full teams to assess deferrals and determine default probability, collateral and evaluate the borrower. Most of the deferrals being requested are from individual loans or property-level debt while most grocery-anchored REITS have the flexibility at the balance sheet level as well as have a more diverse tenant base of grocery / necessity retailers. Similar to the local / independent restaurateurs, the impact of COVID is being felt the most by the smaller ownership groups and local commercial banks.

Communication

Lenders stressed the importance of open dialogue and communication between all parties. Without awareness and transparency, each group reverts to the natural tendency of "just pay me."

The lenders noted that there are a lot of industries – outside real estate and food & beverage – that are also going through acute issues. The biggest question for many lenders is who is the operator and is there solvency in the business.

Transactions

The pandemic has ultimately put a complete halt on many retail real estate transactions. There are three times when owners typically source debt/equity: (i) upon acquisition, (ii) maturity of a loan, or (iii) construction of an asset. As of the end of Q2 2020, the quarterly property sale transaction volume for the retail category was down 73% year over year in dollar volume and 65% in the number of properties sold[9].

Retail delinquencies from a CMBS perspective stood at 18% as of the end of June versus under 4% in March. 14.28% of loans have moved into special servicing (indicating a troubled debt restructuring) verses 5.13% in March[10]. While early, the risk is that there will be a larger pool of assets that move into the delinquent / TDR category. Most banks are trying to work with clients, but they "can't do it

[8] https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200322a.htm
[9] RCA
[10] Trepp

indefinitely." While no bank wants to manage real estate, panelists noted that without any personal recourse and no solvency in the operator, the only element left is the real estate.

In the transactions to date, the single largest issue is in the loan underwriting. Borrowers cannot prove out the NOI of a property in this uncertain environment with tenants not open and or not paying rent. In order to borrow, an owner has to demonstrate adequate cash flow from the property to more than cover its debt service and needs to show that the loan is at a discount to appraised value, in the case of a refinancing, or actual value, in the case of a sale. With so few sales taking place, value metrics are difficult to prove. In other words, the Net Operating Income (NOI or cash flow before financing) has been reduced through lower collections which reduces the debt yield, impacting the size of the loan available to a borrower and the risk associated with the loan to the lender. If an owner cannot obtain the desired debt amount for their capital stack, they will have to put in more equity to make up the balance. For example, a lender requires a 10% debt yield. The NOI in Jan 2020 was $1.2M on a $10M loan, making it a 12% debt yield. In trying to refinance the $10M loan in May 2020, the owner can now only verify $900k in NOI representing a 9% debt yield. The lender will only lend to a 10% yield or $9M and the owner must source the additional $1M of capital to bridge the gap.

With disruption and uncertainty in the retail environment, lenders today are only willing to underwrite credit tenants or they are requiring higher reserves, guarantees, other collateral to ensure no loss on the note. One panelist noted that covid has "disrupted the obligation chains that underpin our entire industry."

A New Deal

Panelists noted that banks, landlords and restauranteurs alone will not find solutions. But together the various stakeholders could come up with a model that has the potential to work and broadcast it to others in the industry. One banker noted that "a bank will trade structure for time."

Other participants questioned what the government – local and federal – could do in helping step in to save communities, and must do to preserve tax revenues… A genuine focus and concern of many local officials.

One municipal participant proclaimed that "the reality is that the value of the land is no longer what it was [pre-covid].", which has negative implications not only for property owners, but also for those municipalities that derive much of their operating budgets from real estate taxes. Cities used to be valuable because of their density… and now everyone is promoting and values distancing. Communication and collaboration are the only way forward.