FATIGUE AND FLEXIBILITY:

Global Real Estate Trends Shift in Light of the Pandemic

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For more than 120 years, Armstrong Teasdale LLP has delivered sophisticated legal advice and exceptional service to a dynamic client base around the world. The firm's robust Real Estate team serves clients internationally and is comprised of and led by dozens of women attorneys who work cross-functionally on diverse transactions, projects and industries. Their global perspective sets the stage to explore challenges and trends in light of the pandemic, including waning demand for brick-and-mortar and enterprising redevelopment. This article taps the deep experience of our women attorneys around the globe who provide insights on how these trends are playing out in different U.S. markets and the U.K.

First, we will explore the urban U.S. markets with a look into how e-commerce has been a game-changer for brick-and-mortar retail in New York. Then, we will head to the Midwest suburban markets to see how the pandemic has culled the landscape of traditional shopping malls and has resulted in a new crop of mixed-use developments. Lastly, we will land in the U.K. to explore how the pandemic has impacted retail on U.K. high streets.

Convenience is Nothing New for New Yorkers

In the years preceding the COVID-19 pandemic, New York City saw a steady rise in retail vacancies. The growing popularity and convenience of online shopping was one of the most significant contributing factors. At the outset of the pandemic, the precipitous reduction in foot traffic caused by office shutdowns, governmental restrictions and a halt in tourism further exacerbated retail's decline. However, as the world emerges from under the cloud of the pandemic, upstart e-commerce based companies, as well as traditional retailers who have adapted their business models to cater to changing consumer behaviors, have begun to refill vacancies and have the potential to transform and revitalize the once moribund retail landscape in New York City.

Government-imposed lockdowns and social distancing guidelines during the pandemic caused consumers to rely heavily on online shopping. Supermarkets and grocery stores in particular saw a noticeable shift toward e-commerce, as customers sought to avoid crowded stores and grew accustomed to the convenience of having groceries delivered directly to their doorsteps.

As the pandemic has evolved, we have seen the creation of new e-commerce grocers that have begun utilizing vacant retail spaces in densely populated residential neighborhoods to more efficiently reach the stay-at-home consumers. In order to fulfill customers' desires to avoid returning to traditional supermarkets, these over half a dozen new web-based grocery delivery services have established brick-and-mortar, delivery-only distribution centers, which are capable of delivering groceries to consumers in record time. As the New York Times recently observed, this development has transformed New York City into "the biggest laboratory for the latest evolution in rapid-ecommerce – a surge of online companies promising groceries at your door in 15 minutes or less..." Although e-commerce companies once forced many traditional retailers to shut their doors, these 15-minute grocery delivery services that emerged during the pandemic are using their e-commerce platforms to once again fill brick-and-mortar storefronts across the city.

As offices reopen and New Yorkers emerge from the confines of their apartments, other companies are turning to brick-and-mortar storefronts to capitalize on the increased foot traffic by adjusting their business models to comport with COVID-19-era consumer preferences. The growing need for in-person shopping combined with consumer favoritism toward digital platforms has given rise to a new hybrid business model – e-commerce based, brick-and-mortar stores like AmazonGo and Starbucks Pick Up.

The AmazonGo stores that have sprouted up across the city illustrate how a brand synonymous with e-commerce is using traditional brick-and-mortar storefronts to serve consumers that have spent much of the last two years shopping digitally and avoiding in-person social experiences. Shoppers with the AmazonGo app enter AmazonGo stores by scanning their phones. Amazon's technology then analyzes the customer's movements throughout the store to determine which items the consumer has selected and how much the items cost. This allows the shopper to simply leave the store when they are finished shopping, rather than having to go through a traditional check-out process often featuring long lines that are not conducive to social distancing.

Like AmazonGo, Starbucks allows shoppers at its Starbucks Pick Up stores to make purchases without having to interact with a cashier. In contrast to Starbucks' traditional business model, which was characterized by its patrons being invited to spend significant amounts of time in the store, Starbucks Pick Up shoppers are able to order and pay in advance through an app, which allows them to take their coffee on the go and avoid lingering indoors. These hybrid models marry the once paradoxical e-commerce and in-person shopping experience, while also responding to customers' continued COVID-19-related apprehensions.

The global pandemic introduced new challenges for office and industrial markets, and in many ways it exacerbated existing challenges in the retail markets. Retail tenants found themselves struggling to serve customers who were unable to shop in person, and later were unwilling or discouraged to shop in person, and were forced to improvise with delivery services, curbside pickup and additional online ordering options. Nationally, this accelerated the adoption of e-commerce platforms for retailers of all kinds, and consumers have gotten used to the convenience of this integration.

Early in the pandemic, many wondered whether the dramatic rise in online shopping and e-commerce would be the nail in the coffin of brick-and-mortar retail. Two years on from the initial declaration of COVID-19 as a global pandemic, the doom and gloom of early pandemic predictions has not come to pass. In fact, consumer demand for e-commerce integration with [brick-and-mortar retail locations] has meant a resurgence in leasing and development of retail amenities.

The Midwest Demands the Best of Both Worlds

Across the Midwest, absorption of vacant retail space increased significantly during the latter half of 2021 and into 2022.[1]

Vacancy in free-standing retail or strip centers has decreased more quickly than in traditional malls. The slow decline of the traditional retail mall, which has been in progress for many years, has accelerated for less desirable malls (by location, tenant mix and other considerations), though Class A malls have rebounded more quickly. Meanwhile, stand-alone or smaller strip centers, particularly those able to offer drive-thru or curbside pickup options, have experienced the most rapid decline in vacancy rates.

As consumers this comes as no surprise: we'd all like to retain access to the convenience of curbside pickup of our weekly household goods and groceries and our favorite takeout orders, prepared by or shopped for by someone else. On the other hand, we'd rather shop in person for some products, and in-person dining and entertainment are experiences impossible to recreate at home. We'd like the best of both worlds, and retailers and commercial real estate owners alike are changing their models to provide it.

In the Midwest, commercial landlords and retailers are focusing on delivering retail shopping experiences that focus on unique experience and surrounding amenities, including entertainment venues, and which allow for the convenient integration of e-commerce and in-person shopping experiences. Open-air shopping centers continue to be a popular way to deliver unique retail experiences, with the benefit of natural air circulation, access to parking areas for curbside pickup, availability of outdoor seating and, in many cases, availability of smaller shop footprints to allow a wider diversity of tenants.

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[1]JLL Retail Recovery 2021

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For Class B and C shopping malls, many commentators have noted the time is ripe for redevelopment into mixed-use centers. Developers in major Midwest cities including St. Louis and Indianapolis are undertaking large-scale redevelopments of defunct malls, bringing entertainment, office and multifamily housing uses into previously retail-only developments. While redevelopments are in progress, commercial landlords are getting creative with pop-up tenants of all types to increase traffic to remaining retailers and promote interest in the redevelopment projects.

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The function of a retail location has also been fundamentally changed by the global pandemic: for retailers, a store is not just a place where consumers go to view, select and purchase goods or services, but also a key component of a retailer's distribution network for online orders (and for online returns), a tailored shopping experience based upon your past purchases or reviews of other online patrons, and a key element of marketing campaigns. For landlords, a retail location is not just a source of income but also an attraction or amenity in a mixed-use development: retail tenants which offer unique customer experiences, integrated with online shopping platforms and artificial intelligence (AI) programs designed to tailor shopping experiences to individual consumer preferences, and which are conveniently located within mixed-use developments are themselves an amenity landlords can tout to attract residential, office and other retail tenants.

The global pandemic has also, at least temporarily, significantly changed the commercial leasing landscape. Before COVID-19, provisions like *force majeure* (defined as "Acts of God"), impossibility or excuse of performance were boilerplate language relegated to the back of legal documents, rarely read and even more rarely negotiated. Today, force majeure is a key element of any commercial lease negotiation, with both landlords and tenants alike wanting to be sure of their rights and responsibilities in the event of a future pandemic, government-mandated shutdown, local or regional occupancy limitations, etc. Landlord control of common areas in multitenant shopping centers is also a critical issue; as landlords discovered, the right to reallocate parking or outdoor space to curbside pickup spaces or outdoor seating areas was of critical importance to the survival of tenants during the initial reopening subject to pandemic restrictions. As tenants discovered, the right to request additional outdoor space, add temporary signage or protect the visibility and accessibility of their premises was also critically important.

In the Midwest, especially in suburban developments, commercial landlords wanting to quickly fill or refill retail or mixed-use space are increasingly open to flexible lease arrangements, with shorter terms, early termination options, more open assignment and subleasing provisions, and more tenant concessions. Retail tenants can expect the upsides of these flexible arrangements to be mitigated by claw-back provisions in the event of default or exercise of an early termination option, but generally retail leasing is more tenant-friendly than in years past as landlords seek to quickly fill vacancies and recover from shortfalls during 2020 and early 2021.

Savvy commercial landlords have also taken the opportunity since the onset of the global pandemic to negotiate rights to redevelop retail, office and mixed-use properties, or to exercise existing redevelopment rights in their leases, to be able to respond to changing consumer demands and government regulations. Full-scale redevelopment of existing shopping or mixed-use centers has been used to provide updated amenities, modify space for temporary "pop-up" retailers, and add space for a wider diversity of uses. Some commercial landlords, in response to consumer demand for residential space, have initiated redevelopment of purely office or retail developments to include multifamily housing offerings.

U.K. Consumers Have Come to Expect More

The COVID-19 pandemic had an impact on the health of the U.K. real estate industry in addition to the health of the population. The domestic industry comprises almost 5.1% of the U.K.'s gross domestic product (GDP) and forms an integral part of the U.K.'s economy. "Stay home. Protect the NHS. Save lives." was a predominant national slogan as the pandemic took hold. In March 2020, stores, restaurants and offices were forced to close. Staying at home, working from home, and shopping online turned into the new norm.

U.K. e-commerce was already a well-established threat to brick-and-mortar retailers prior to the pandemic, and with the majority of the population now confined to their homes, consumers embraced online shopping for everyday necessities as well as luxuries to ease lockdown fatigue. The challenges imposed by the pandemic prompted and accelerated changes in the commercial real estate market. In the first quarter of 2020, e-commerce made up 20.3% of total retail in the U.K. By the second quarter, this share had risen to 31.3%.

This imposed a challenge to an already-weak U.K. high street, a main commercial or shopping thoroughfare, suffering from high costs and lack of innovation. Brick-and-mortar retail has been in decline since the 2008 financial crisis, and since 2010, nearly 1,400 retailers have entered administration struggling with the impact of online retail. Several large retailers – such as Debenhams, one of the largest U.K. department stores – were forced to close. Others have rationalized. John Lewis, a previously successful high street retailer, has streamlined and moved the bulk of its expected future business online.

Recognizing the need for structural change, central government introduced a new use class which created a flexible town center. Class E allows an easy switch between, for example, cafe, restaurant, retail, office and gym, without the need for a separate planning approval, giving more flexibility to property owners and their occupiers.

High streets up and down in the country have suffered, with some feeling the impact more than others. City centers that were thriving pre-pandemic, such as London, Cambridge and Oxford, suffered more than Wigan or Blackpool as their pre-pandemic strength being the office workforce was required to work from home.

The Government business grants allocated the same amount of funds for the thriving cities as for the poorer cities, despite the second having lower running costs and a smaller shortfall due to lost sales. This may have "levelled down" high streets, but still those places which had the highest number of empty units pre-pandemic faced the biggest challenges. Bradford, for example, has seen almost no change in its vacancy rate, but despite this still has one of the highest vacancy rates in the country. At the other end of the spectrum, Cambridge may have taken a bigger hit, but still ranks among the bottom 10 places with the fewest vacancies.

Central Government also introduced the furlough scheme and the business rates holiday aimed to help retailers. Despite this governmental help, many establishments have closed, never to reopen. Both landlords and tenants have suffered. Landlords have faced rent defaults and voids as tenants were unable to operate and meet their contractual obligations.

The pandemic, however, was not the only factor to impact the U.K. retail market in recent years. On New Year's Day 2021 the U.K. began a much publicized and debated new relationship with the European Union. The uncertainty following the Brexit referendum took a toll on the British economy. Customer spending initially declined as a result of low consumer confidence in the future of the economy. The Wall Street Journal reported that total sales fell in 2019 by 2.7% from 2018, while same-store sales declined 3%. The drop was most severe for non-food sales, which dropped 4%. According to a Drapers Online report in 2019, Brexit was at the top of retail shoppers' worries, reported by 48% of survey respondents as a concern on their minds. Brexit brought other challenges including the disruption of supply chains, especially for businesses that had close ties to the EU and goods becoming increasingly expensive.

The U.K.'s exit from the EU coupled with the pandemic meant that the retail market in the U.K. had to change. Thus far, 2022 has been another interesting year for the sector which looks to shake off these challenges. The outcome will define the future shopping experience.

New online behaviors are now cemented. Consumers have overcome barriers, e.g., setting up online accounts and providing payment details. Research shows that U.K. retailers will reach an additional £19.6 billion of online home deliveries by 2025. It is estimated that 27.3% of U.K. consumers will permanently shift their shopping online. This trend is undoubtedly driven by a large number of the population benefiting from hybrid working and enjoying the convenience of home delivery. The consequence of this is that 35.8% of U.K. consumers expect to visit physical stores less in the future.

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COVID-19 has accelerated the adoption of e-commerce, but how has the high street fought back? Stores have reopened. Customers are finally now able to enjoy the personal experience, and that is the success of the high street that was so long undervalued. Online brands can deliver convenience, lower prices and speedy delivery, but they cannot compete with human interaction. Good service is more than a computer algorithm. Retailers are offering added value. Some stores like Nike and Adidas on London's Oxford Street attract customers to their physical stores by offering in-store personalization of products, flagship exclusives, live DJs and music – a contrast to the pre-pandemic position of companies often operating without online businesses, with tired stores and mediocre customer service. Consumers now expect more.

High streets now offer users experiences that go beyond purely retail or functional-oriented activities. Stores have adapted to become a multipurpose experience destination, integrated into a digital and online offering with rapid, local fulfilment. The end result is that brick-and-mortar retail is aligning to work very much in parallel with, and not in competition to, e-commerce.

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The future of the high street looks brighter than pre-pandemic. High street businesses are in a stronger position than in 2020. Caution dictates that we balance the optimism with the wariness that the immediate rush to the high street will slow down once the urge to 'return to normal' declines. Time will tell. The high street may require external support to reach its full potential. The massive oversupply of retail space will need to be addressed and, ideally, repurposed for other uses providing opportunity for entrepreneurial developers. This will require sensitive and constructive support from the planning regime to enable the equilibrium between supply and demand to be reestablished. The relationship between landlords and tenants will also need to be redesigned to ensure sustainable arrangements that benefit all stakeholders, including imaginative lease terms, e.g., turnover-based lease rents, revised lease breaks and carefully negotiated force majeure clauses.

In essence it has been a challenge for U.K retailers as the population likes to shop and enjoys the in-person experience. The high street is capitalizing and needs to continue to do so despite other emerging pressures on the economy and, where some can't, the entrepreneurs need to be waiting.

Flexibility for the Future

While the pandemic's impact on different geographic markets is varied, the theme is the same – the pandemic has, at least temporarily, changed consumer behaviors in a way that has had a profound effect on brick-and-mortar retail space. As a result, retailers are responding by adapting to consumer demands and property owners are turning to novel approaches for utilizing and redeveloping space. The landscape continues to evolve, and the name of the game is flexibility. We are seeing this consistently with clients in how transactions are being negotiated and documented – from redevelopment agreements to leases – and that willingness to flex has proven beneficial in our experience.

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