SPECIAL SITUATIONS ADVISORY

NAVIGATING THE TENANT/LANDLORD RELATIONSHIP POST PANDEMIC

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TENANT AND LANDLORD RELATIONSHIPS

NAVIGATING THE TENANT / LANDLORD RELATIONSHIP EXITING THE PRESCRIBED PERIOD

The end of the rental moratorium (30 June 2022) couldn't have come at a worse time for retailers with inflationary pressure on inputs, rising interest rates, ongoing labour shortages and the Australian Tax Office pressing for repayment of COVID-19 period tax debts. Over the last two years, the NSW and VIC Governments mandated negotiations between tenants and landlords with the objective of achieving a fair and reasonable outcomes for all parties.

Despite good intentions, the Code of Conduct has resulted in a myriad of issues across both retail and commercial tenancies, with landlords and property operators viewing the Code of Conduct as an interventionist policy due to the financial impact on private contracts between tenants and landlords. This has understandably taken its toll, resulting in strained relationships between tenants and landlords following drawn out negotiations while accrued liabilities continue to rise for both parties.

Growing arrears and deferred rent liabilities will come to a head for tenants who are unable to provide landlords with comfort surrounding their ability to service repayment of rental arrears and deferred rent. Tenants and landlords alike will face considerable pressure over the coming months to finalise negotiations and make informed decisions surrounding lease variations and terms. Landlords will also need to make informed decisions surrounding the financial viability of tenants and their ability to service rent repayments under the lease.

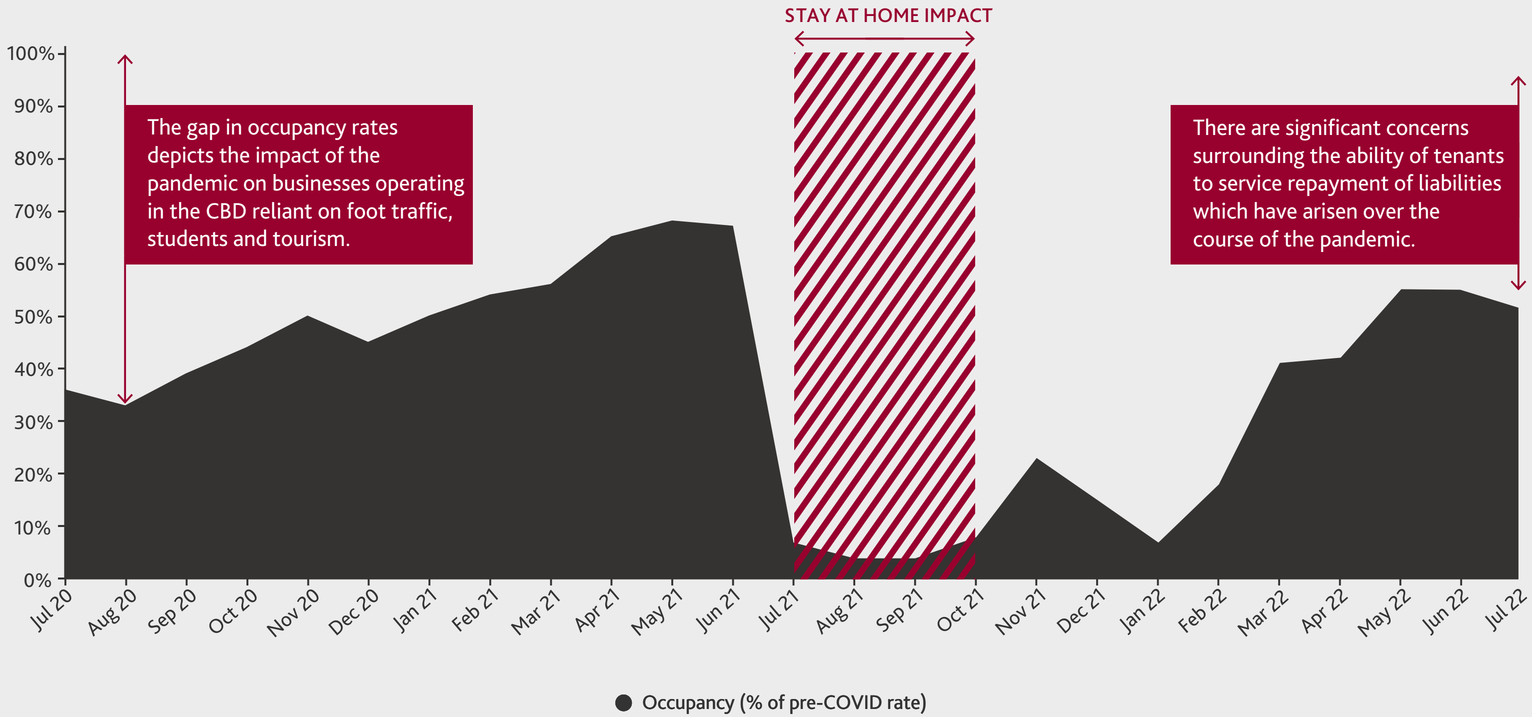
This article outlines the key challenges faced by tenants and landlords in the current market and some insights to assist in navigating the next 2 years.

SYDNEY CBD OCCUPANCY RATES

PCA's occupancy rates depict the impact of government restrictions on the Sydney CBD. The below chart presents the change in landscape for businesses reliant on foot traffic in the CBD for revenue. Despite the relaxation of NSW regulation over the past 3 months and employers incentivising employees back into the city, occupancy rates remain at 55% of pre-covid levels as at 31 May 2022.

This raises concerns for businesses reliant of CBD foot traffic such as retail, tourism and education providers, and their ability to service repayment of liabilities arising from the pandemic.

OCCUPANCY RATES AS A % OF PRE-COVID RATES



Source: PCA occupancy rates and BDO analysis

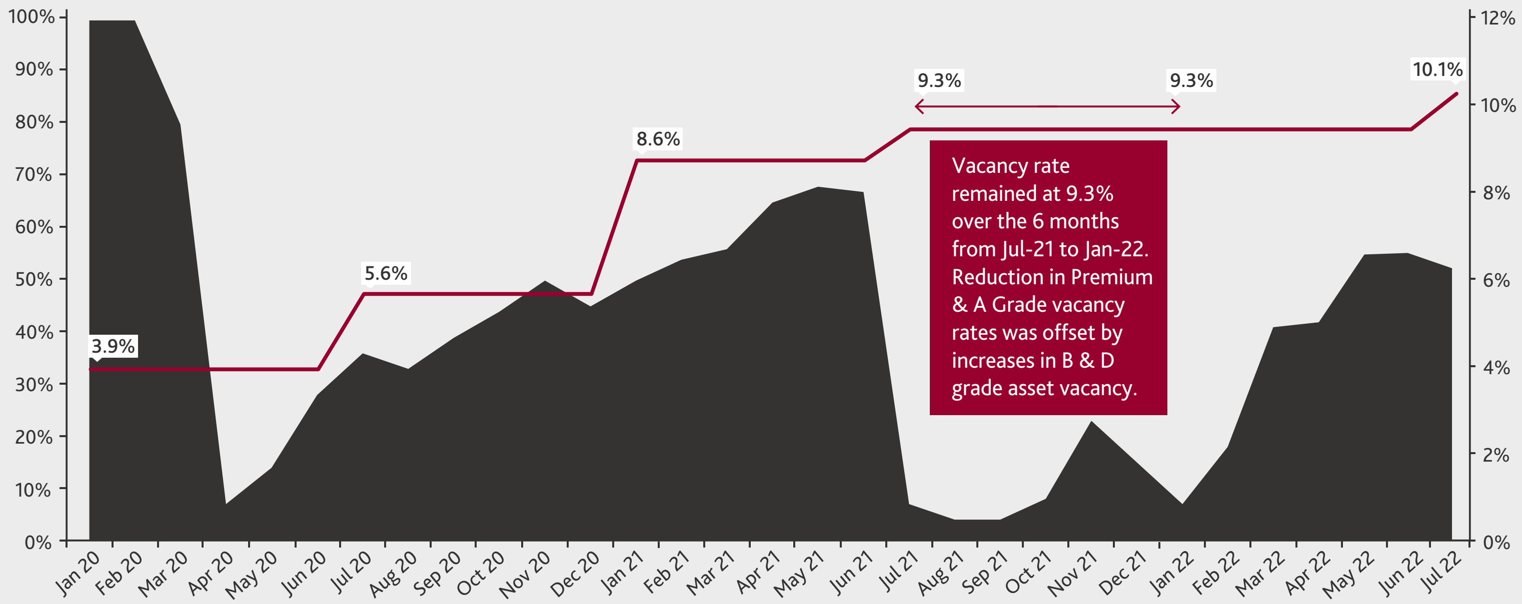
BDO OUTLOOK

- Low occupancy rates have placed significant stress on tenants to reduce costs and pivot their business while liabilities continue to accrue. Despite occupancy rate growth over the past 6 months, we anticipate this growth will be largely offset by tightening up in discretionary spend due to rising interest rates and general cost of living. This is particularly a concern for retail tenants who have been unable to transition to online.
- The next 3 months will be pivotal for business survival and ensuring there is a viable financial plan that can be agreed with all business stakeholders (including landlords, ATO and banks). If you are facing signs of distress or growing liabilities off the back of the pandemic, we recommend early intervention with the help of an advisor from BDO to engage with key stakeholders.

SYDNEY CBD VACANCY RATES

The below chart presents PCA's bi-annual Sydney CBD vacancy rates against the occupancy rates detailed on the previous page. Vacancy rates have increased significantly over the past 24 months from 3.9% (Jan-20) to 9.3% (Jan-22) driven by tenants downsizing or transitioning to a hybrid workplace model, and technological advancements (i.e. the NBN network and rise of cloud computing), allowing many businesses to become increasingly mobile.

VACANCY RATES VS OCCUPANCY RATES



Source: PCA occupancy rates and BDO analysis

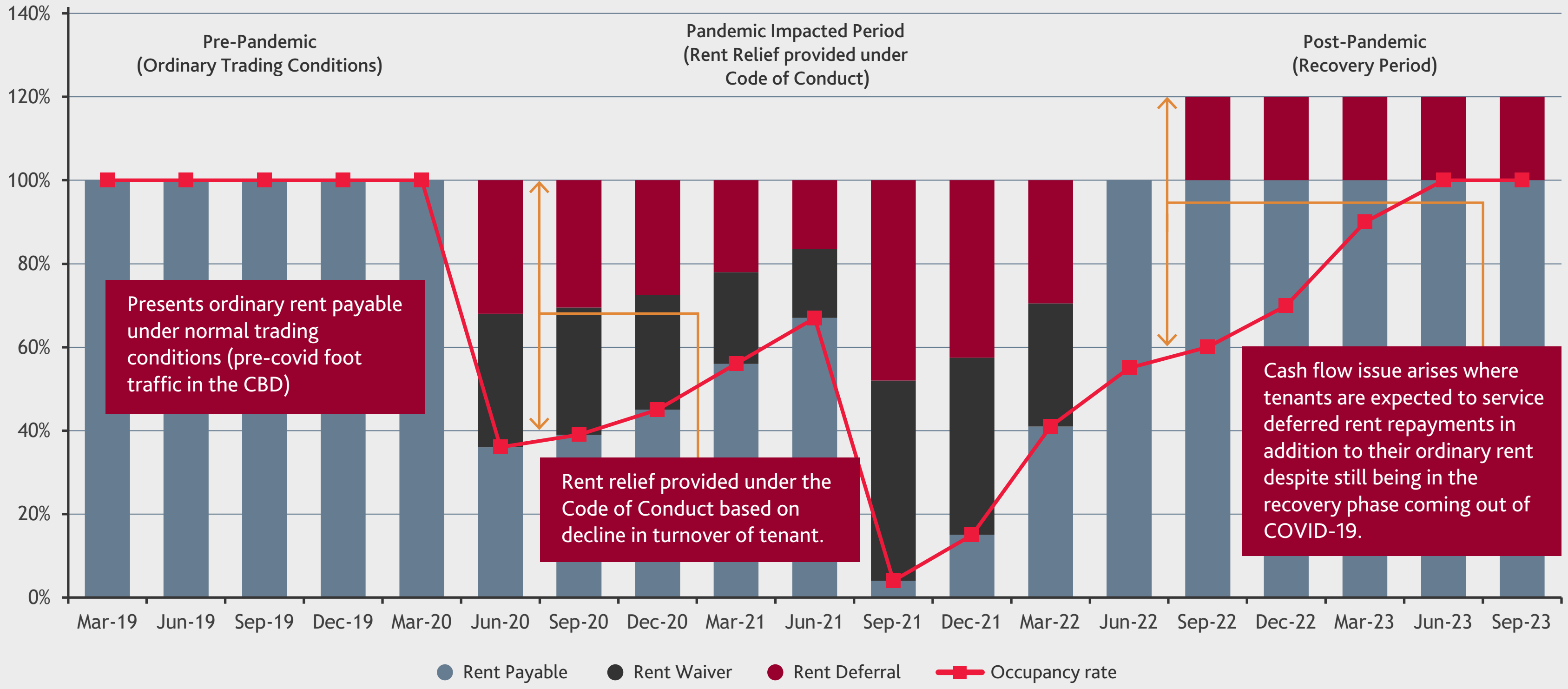
BDO OUTLOOK

- Landlords with exposure to CBD real estate assets (retail or commercial) will face significant financial pressure in maintaining pre-covid financial performance. Due to the extremely competitive nature of tenant retention and incentives required to let space in the current market, negotiations are heavily favoured to tenants.
- Over the next 6-12 months, we anticipate there to be a growing rise in DOCA's, where business will use a formal restructuring process to compromise accrued rental liabilities and tax arrears. In these circumstances, landlords will find themselves in a difficult position with limited time and information to make informed decisions surrounding whether to support the tenant through the restructure or not.
- Engaging BDO to perform a tenant viability review (outlined on page 7), will allow landlords to predict with greater confidence which tenants will be at risk of DOCA and provide greater visibility over the financial position of the tenant to negotiate.

FINANCIAL IMPACT TO TENANT

The below chart presents the financial impact to tenants from a cash flow perspective with regards to servicing ongoing rent repayments split across three periods being 1) pre-pandemic, 2) pandemic impacted, and 3) post-pandemic. It is clear that despite cash flow relief being provided to tenants, tenants with exposure to CBD foot traffic are still recovering and will face considerable cash flow pressure when asked to repay deferred rent amounts above their ordinary rent.

EXAMPLE: TYPICAL TENANT RENT CASH FLOW



Source: PCA occupancy rates and BDO analysis

KEY CONSIDERATIONS FOR TENANTS AND LANDLORDS

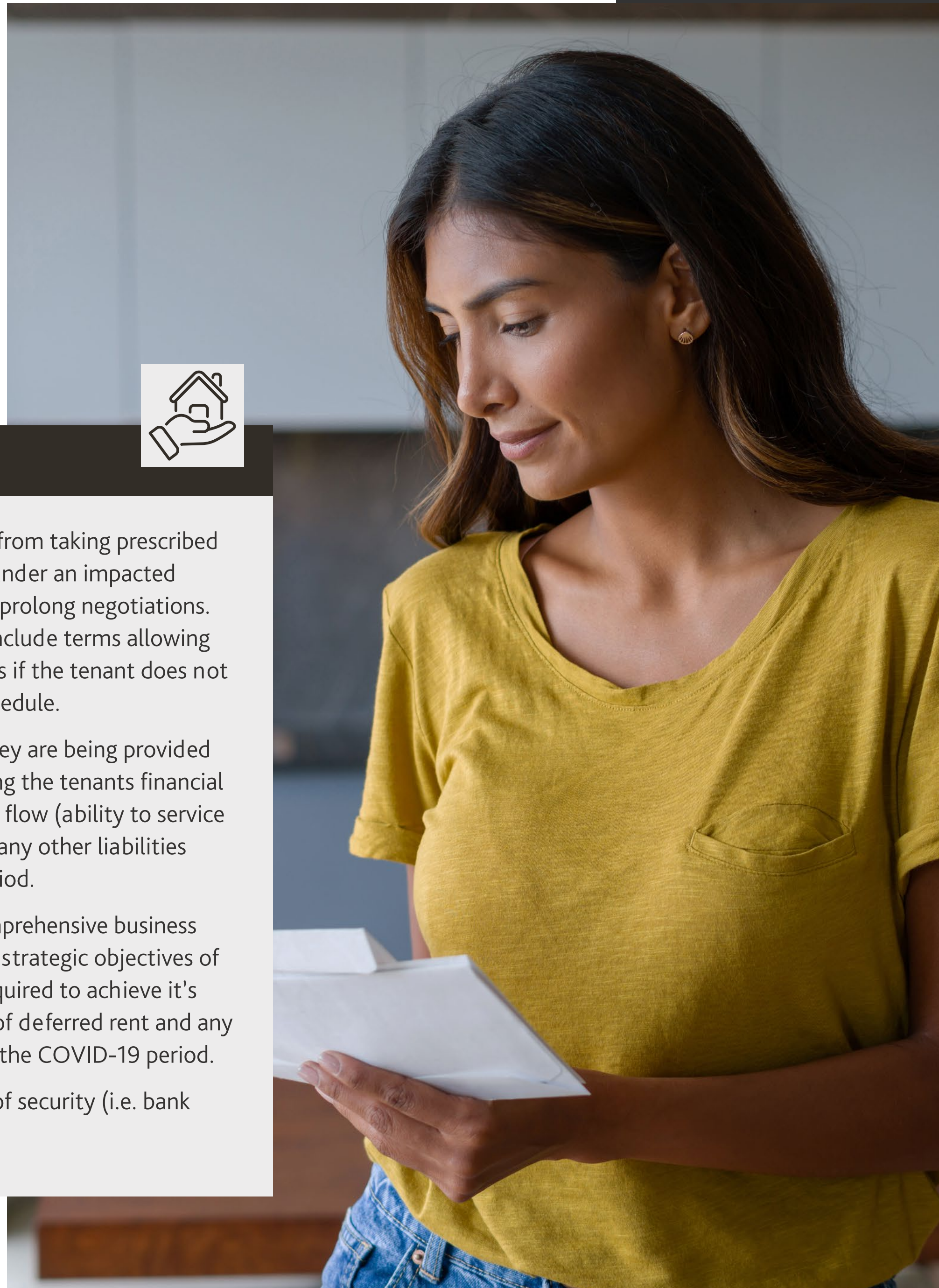
Key issues arising and the impact for both tenants and landlords is detailed in the table presented below.

TENANT

- Ensure early engagement with landlords to communicate issues arising with business both from a financial and operational perspective (transparency is key to maintaining a strong relationship).
- Tenants need to model various scenarios considering the impact of COVID-19 to ensure informed decisions are being made by management in understanding cash flows, accrued liabilities and liquidity. In particular, over the next 6-12 months as businesses transition out of COVID-19.
- Development of a comprehensive business plan which includes a detailed repayment schedule that can be linked to and supported by financial information (historical and forecast) and KPI's of the business.

LANDLORD

- Landlords have been restricted from taking prescribed action (including termination) under an impacted lease allowing some tenants to prolong negotiations. Renegotiations of rent should include terms allowing the landlord to enforce its rights if the tenant does not comply with the repayment schedule.
- Landlords should also ensure they are being provided with sufficient detail surrounding the tenants financial position including forecast cash flow (ability to service deferred rent repayments) and any other liabilities accrued over the COVID-19 period.
- Landlords should request a comprehensive business plan that clearly articulates the strategic objectives of the tenant and the roadmap required to achieve it's plans including the repayment of deferred rent and any other outstanding arrears from the COVID-19 period.
- Consideration of exposure net of security (i.e. bank guarantees) and vacancy risk



TENANT VIABILITY REVIEW

HOW CAN BDO HELP?

Tenant Financial Viability Review

If required, a tenant financial viability review involves a detailed assessment of a tenants forecast cash flows and the tenants ability to repay rent and any agreed rent deferral amounts transitioning out of the prescribed period.

The objective of these reviews is to:

1. understand the financial position of the tenant;
2. identify what would be considered a reasonable recovery period (repayment period);
3. navigate a mutually beneficial outcome for the tenant and landlord in respect to relief offered; and
4. inform the landlord finance team surrounding doubtful debts provisioning

The goal here is to paint a full picture for the tenant and landlord around what the tenant will realistically be able to afford to repay based on historical and forecast financial information with the hope of allowing tenants to survive for the long term (improving retention rates and limiting risk of vacancy for landlords).

Conversely, the review will also identify any red flags in respect to solvency issues the tenant may be facing to ensure landlords do not continue to accrue debts the tenant simply will not be able to repay.

HOW CAN BDO HELP?

Our Special Situations Advisory team are experts in conducting cash flow reviews that highlight the current shortfalls of a business' working capital position. Our team assist businesses understand these key focus areas and work to identify unique opportunities for your business to promote success in the post-pandemic environment. Our cash flow review services include:

- Understanding your current operating environment and your working capital & cash conversion cycles.
- Assisting to build a rolling and sensitised cash flow forecast with an eyes up approach to upcoming expenses and potential shocks to the operating environment.
- Utilise benchmarking of working capital KPI's to promote the identification of improvement opportunities for your business.

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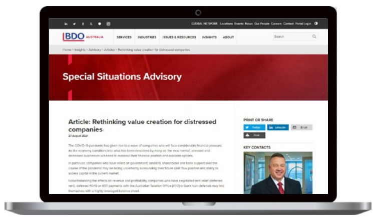

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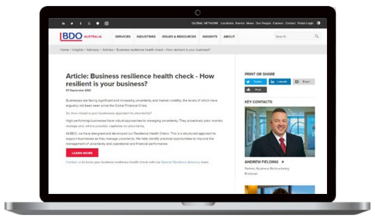

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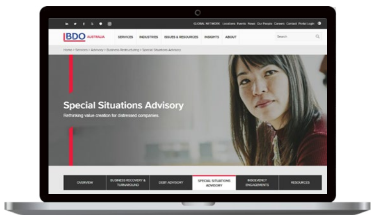

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