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USA Regional Real Estate

Pennsylvania: Trends & Developments
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chambers.com

2020

PENNSYLVANIA

Trends and Developments

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Trends and Developments
In reviewing real estate trends and developments, the last twelve months must be divided into two major segments: BC (before COVID-19) and AC (after COVID-19).The COVID-19 outbreak in the US occurred simultaneously with the precipitous decline in the stock markets.On a near-term basis, both events are likely to have a significant impact on real estate and issues important to attorneys.

General
Before COVID-19 (BC)
Most sectors flourished in Pennsylvania, with Multi-family Residential and Industrial leading the way. Unlike previously years, however, all boats appeared to be floating. Hospitality was robust. Suburban Office, anemic in prior years, showed signs of coming out of the doldrums, especially at the trophy-end, with new projects commencing at starting rents never seen before. Retail held its own and even absorbed some vacant space. "Qualified Opportunity Zone" projects – projects made possible by tax changes in the 2017 Tax Cuts and Jobs Act – gained some steam in 2019 as guidelines clarified some of the concerns investors had.

After COVID-19 (AC)
Governor Tom Wolf of Pennsylvania issued two Executive Orders, one on March 19, 2020, prohibiting operations of businesses that are not "Life Sustaining," and a second on March 23, 2020 (initially for select counties, extended to the entire state by the end of March), requiring residents to stay at home unless they have life-sustaining activities to perform. That order was upheld by the Supreme Court of Pennsylvania in Friends of DeVito v Wolf, 2020 WL 1847100 (2020).

Tenants in many sectors are either threatening to withhold rents or actually have done so. This has led to borrowers' inability to meet debt service payments, and lenders generally are being responsive. Hospitality has been particularly hard-hit. Restaurants and retail are also experiencing unprecedented lows.

For smaller businesses (less than 500 employees), the Small Business Administration (SBA) has available Economic Injury Disaster Loans and Payroll Protection Program loans with very favorable terms, and some landlords are encouraging tenants to obtain such loans so they can pay the rent.

In requesting or demanding concessions, many tenants, whether their leases or law allowed them to or not, invoked the legal concepts of force majeure, impracticability of performance, and frustration of purpose. These principles are related and overlapping but distinguishable from one another. Tenants may also begin to utilize language in the DeVito case to rely upon casualty language in their leases for additional relief.

Force Majeure
Force majeure refers to, generally, provisions in contracts that relate to what happens in the event there are acts of god, war, insurrection, and potentially a whole slew of other factors that have been added over time to address similar situations. Customary force majeure clauses often include, among other things, labor disputes, acts of government and terrorism, to name just a few. Often, force majeure clauses contain a "catch all" to refer to other issues not specifically listed. Historically in Pennsylvania, these "catch all" phrases have only been honored by courts to the extent they are similar to specifically enumerated items. Beyond generic force majeure clauses, many leases contain clauses that permit tenants to abate rent during periods of casualty and also to terminate a lease if the casualty persists for a period of time.

Impracticability
Impracticability, or impossibility, is a relatively old common law concept that states that if a fundamental assumption underlying a contract becomes false, the contract is voidable. For example, if a contractor is hired to put a roof on a house, and a day before the contract work commences, the house burns down, it will be impossible for the contractor to install the roof. In Pennsylvania, these clauses are more broadly interpreted if there is no contractual term directly addressing the condition.

Frustration of Purpose
Frustration of purpose is similar to impracticability. It is a situation in which the contract can be performed, but it would be pointless to do so. For example, assume a lodging owner contracts with a lodger under which the lodger is to pay the owner USD1,000 for a room with a view of a parade. The parade

is then canceled. The purpose of watching the parade is frustrated; therefore the contract is voidable. Pennsylvania courts seem to have trouble distinguishing this line of cases from those discussing Impracticability (see above), and the two are often mentioned together in the cases as if they are indistinguishable.

These arguments, and the stark reality of the situation, have led some landlords to make or consider concessions to their tenants. The concessions vary from rent forgiveness or deferral to tenants to outright terminations of leases. Some lease modifications require the tenants to agree to term extensions or higher rents in ensuing months. Lease terminations, where available, may require high upfront payments. The level of the generosity of those concessions varies with the temperament of the landlord, the bargaining leverage of the tenant and the willingness of lenders to offer the landlords comparable concessions.

Industrial/Warehouse Real Estate

BC

Before COVID-19, industrial and warehouse real estate continued to be gobbled up with relish by the development, investment and end-user community. As millennials increased in purchasing power and even seniors learned how to order groceries on their computers, the demand for massive warehouses continued unabated. According to Jones Lang LaSalle (JLL), vacancy rates in Eastern and Central Pennsylvania remained around 5%, and a staggering 16.4 million square feet of space was absorbed in the eastern and central portions of the state in 2019, with nearly 20 million square feet under construction (actually representing a slight decrease from the preceding year). Over half a billion dollars worth of large industrial projects traded hands in central Pennsylvania alone.

Technology, particularly robotics systems, became more and more a part of the new generation of warehouses in 2019, and some older warehouses are being retrofitted to accommodate these systems. Lawyers need to become aware of a number of issues that can arise as a result.

The construction of a warehouse now often involves both “bricks and sticks” and expensive “smart systems” that may not be installed by the same general contractor that builds the building, requiring coordination between multiple contractors.

Additionally, customers will want some systems installed in a still-operating warehouse, requiring careful discussion of how to avoid the installations interfering with ongoing operations.

Finally, there may be a blurring of the lines between what is real property and what is personal property, requiring lawyers to make sure which area of the law governs which portion of the project. [Note: once upon a time, Pennsylvania had an “industrial plant doctrine” that minimized the problems created by that distinction, but that doctrine has been eliminated.]

AC

Industrial/warehouse real estate is perhaps the one type of real estate that is not anticipated to be affected negatively (except perhaps temporarily) by COVID-19. In the very near term, supply chains have been disrupted, making it difficult for goods to get to warehouses. In the slightly longer term, a recession could lead to fewer discretionary purchases which might decrease some volume, though certain sectors have seen spikes which may continue (toilet paper manufacturers and personal fitness equipment suppliers seem to be doing well). Additionally, decision-making has slowed and may continue to be sluggish while specific industries determine whether to commence new projects or relocations.

Ultimately, however, insiders expect that the current call for social distancing will accelerate the long-term trend of individuals shunning retail in favor of having products brought to their door. If anything, the future of industrial real estate is even brighter than it was before. Given the disruption in the supply chain caused by the COVID-19 pandemic, warehouse users are attempting to determine how to avoid or mitigate such disruptions in the future. Accordingly, such end-users are expected to carry higher inventories and seek out multiple supply sources.

Multi-family

BC

The year 2019 saw investors continue to crave this product, and leasing activity continued to be strong. Absorption of new products, especially in the higher end of the rental market, proved the investment community right. Institutional property owners report that, for Philadelphia, there was a 5% growth in rent for the second year in a row and a 22,000-household increase. Demand continued to be strong particularly for buildings with modern, common amenities, such as fitness rooms and common work space and that are either downtown or close to mass transit.

AC

People will still need to live someplace and, with capital markets gyrating, employment uncertain and physically getting to new residences a challenge, people are generally staying where they are and are likely to be slow to move in the near term. Indeed, many buildings are not permitting showings for prospective tenants and buyers. Additionally, existing buildings under construction were told to stop work by the “stay at home” order of the Governor. That order was lifted as to contractors effective May 1st, though some contractors received waivers to continue to one degree or another throughout the “stay at home” order. The halt in new supply is good news for owners of existing buildings, especially those that are already leased up or close to it.

In the longer term, it will be interesting to learn whether common amenities and mass transit will continue to attract residents or whether social distancing will have a lasting impact and residents will prefer larger internal spaces and garages in order to bring their amenities into their homes and, if they do travel to work, commuting by car. Additionally, at some point, family formation and growth will push younger people into suburban homes. The question will be whether the empty nesters will continue to be interested in the city or whether they will want to retain the separation that the suburbs afford. If the latter, single-family development is likely to surge while multi-family may lag.

Office

BC

Urban areas continued to see increases in absorption, particularly of trophy space, with rents in some locations topping USD50 per square foot and many other trophy spaces exceeding USD40 per square foot. Philadelphia saw the opening of the long awaited new 60-story Comcast Technology Center at 19th and Arch Streets. For the first time in a long time, suburban Philadelphia locations saw the commencement of new construction of office buildings exceeding 1,000,000 square feet (primarily due to a pair of new buildings in Conshohocken).

Pittsburgh also got into the act, boasting the commencement of a new 400,000 square foot USD200 million tower, the first such office building in nearly a decade. According to Cushman & Wakefield, rents in the Oakland district of Pittsburgh also reached USD50 per square foot in spaces, though the Strip District is closer to a still healthy USD35 per square foot.

According to Technical.ly Philly, co-working spaces in Philadelphia exceeded 1.1 million square feet in 2019, as more people viewed shared workspaces as a viable work option.

AC

Most tenants generally were unable to use offices, as the Governor of Pennsylvania ordered non-essential businesses to close on March 19, 2020. Although most landlords kept their buildings open, the level of services (including heat and air conditioning, at times) decreased. Those tenants either have asked or may ask for rent relief.

The long term outlook for offices remains murky. Recessions generally are not kind to offices; as headcounts decrease so does the need for space. In this case, though, there is an added dynamic of social distancing. On one hand, that might lead to companies changing their work models so that remote working might become a viable permanent solution for many companies.

On the other hand, the forced isolation may cause others to value the benefit of office locations but cause them to re-think their office and furniture configurations, with bench–seating being eliminated in favor of cubicles or even a return to more segregated offices. If that occurs, there could be additional demand for space as tighter configurations give way to more spacious ones.

Retail

BC

Prior to COVID-19, retail was steady if not spectacular. Vacancies in 2019 were minimal and there was even some net absorption in some locations. Asking rents in Pittsburgh inched up 1.4% and vacancy rates were in the 6.4% range according to Cushman & Wakefield. In the Philadelphia metropolitan area, big-box retailers absorbed nearly one million square feet in 2019, according to CBRE, though there was not significant construction of new space.

AC

If the industrial sector looks like the sector that will emerge even stronger from this event, few retail segments are likely to survive it unscathed. Exceptions may be companies that have already embraced technology and rely as much or more upon internet sales as bricks-and-mortar store sales.

If office tenants are asking their landlords for breaks, retail tenants are telling their landlords not to expect payments. Bankruptcies of large retail chains may be the only rational way of getting these companies through the crisis.

Hospitality

BC

Hospitality was a booming sector before COVID-19. According to the *Philadelphia Business Journal*, room revenue increased over 5% to a record USD707 million while revenue per available room (or "revpar") also was up, to USD154 on average, and average daily rate soared to over USD200, also a record. Philadelphia saw its first new upscale lifestyle club in decades, the Fitler Club, open to a warm reception. The Four Seasons Hotel atop the new Comcast building also opened, with two high-end restaurants.

AC

The COVID-19 pandemic has devastated the hospitality industry. Even as early as March 11th, the local Philadelphia ABC affiliate was reporting that hotels that had been at 80% occupancy were down to 30%, and that figure has only fallen since then. Conventions at the Pennsylvania Convention Center have been cancelled at least through May 2020 so that has had an additional impact on the hotel industry.

It appears that vacation rentals have spiked, forcing Governor Wolf to place short term rentals on the non-exempt list as a "non-essential" business as of March 31st, after the Pocono Mountain Region, a popular vacation area in eastern Pennsylvania, became the location with the highest per capita cases of COVID-19. In the slightly longer term, a recession can't be good for hospitality which relies significantly on business travel. Additionally, as restrictions are loosened on travel, large gatherings such as conventions are likely to be the very last type of public gathering that resumes, deepening the hospitality industry's woes.

In the longer term, the businesses (such as consulting) that previously required travel may re-think how much on-site work is truly necessary, especially if the clients also work remotely. Face-to-face interactions with clients may be more virtual.

Natural Gas

BC

As of the end of 2019, Pennsylvania had become the nation's second largest producer of natural gas, after Texas. While that brought sudden wealth to people in many of the rural regions of the state, particularly in the southwest and northeast, the bloom appeared to be coming off the rose in 2019. True, production was at an all-time high, according to the Independent Fiscal Office, but the growth in production was slowing and the number of active wells had decreased. Worse, prices had also plummeted, according to the Energy Information Administration. Chevron, among others, had already taken a large write-down of assets attributable in large part to its Pennsylvania gas shale assets.

AC

Governor Wolf conspicuously called gas wells an "essential" activity permitted to keep operating while most other businesses were required to cease operations. How much this will aid the ailing industry remains to be seen. *The New York Times* summed it up on March 31, 2020, saying: "as the region braces for the COVID-19 recession, natural-gas companies are much more likely to weigh on the local economy than to rescue it." Oil prices have fallen as the result of a failure of oil producing nations to arrive at a consensus on supply limits and are likely to fall further because of a limitation on demand arising from COVID-19. This, in turn, is only likely to push down prices for gas further.

Real Estate Lending

BC

Real estate financing mirrored the sectors above. Multi-family rental properties and student housing continued to be preferred investments. Loans secured by industrial properties with credit tenants were sought after, but lenders also justified making loans for industrial properties and other properties with potential upsides (so-called "value-add" properties) as well. Office and retail properties that were leased up (or, in the case of construction loans, pre-leased) were financeable if not necessarily preferred.

AC

As noted above, real estate lenders are being inundated with questions and demands from borrowers regarding delays in payments. Most lenders appear to be receptive to legitimate requests from borrowers where the borrowers can demonstrate hardship. Others have become proactive and actually sent out modification terms to borrowers as a group.

Conventional lenders have, for the time being, emphasized that they remain open for business. They tend to prefer the loans that they preferred in 2019, and they tend to prefer working with existing customers or customers that have a proven track record. Underwriting appears to have tightened: loan to value ratios have fallen, leasing is reviewed more critically, and future assumptions are scrutinized. Borrowers for construction loans will need to prove that they can obtain all permits as well as the materials and labor needed to build. Nevertheless, conventional lenders are continuing to lend.

The one segment of the market that has completely closed shop is the Commercial Mortgage Backed Securities loan market. Due to gyrations in interest rates, hedging mechanisms and other peculiarities of that market, mortgage servicers of such loans are in distress, and the market itself will need intervention to re-ignite itself. Unlike 2008, the expectation is that the federal government will purchase "agency-backed" CMBS loans. The industry hopes those purchases extend to the purchase of other CMBS loans, though as of this writing that has not yet occurred.

In the meantime, less traditional lenders remain available. Schooled in previous downturns, many, if not most, fund operators have distressed loan funds that are specifically designed to ramp up during times like these. Some of those lenders enter into secured debt such that, if the borrower is able to pay, the lender is happy to be repaid, but if the borrower defaults, the lender would not mind owning the property.

Qualified Opportunity Zones

As noted in the general comments above, Qualified Opportunity Zones did gain some traction in 2019 as investors rolled gains tax-deferred into funds destined for the new zones, though the pace of the projects was not what some had been expecting. "There hasn't been a tidal wave of opportunity zone projects," said Jessica Millett, of Duval & Stachenfeld LLP, which services opportunity zone clients nationwide, include those with investments in Pennsylvania, "but it's a thriving industry. It's definitely freed up capital that was sitting on the sidelines." She also notes that she has received inquiries about Qualified Opportunity Zone investments even after the COVID-19 pandemic was in full swing. So perhaps that segment will be early out of the gate when things begin to recover.

Conclusion

The COVID-19 pandemic has temporarily disrupted the entire world, and the real estate world in Pennsylvania is no exception. The implications are only beginning to become clear.

Hangley Aronchick Segal Pudlin & Schiller offers specialized legal solutions to a broad range of local, regional and national clients. The firm is highly regarded nationally for its quality work, innovative strategies, and excellent results. The firm's real estate lawyers guide and counsel clients through all aspects and phases of their real estate transactions, from deal structuring to restructuring, from acquisitions and sales to zoning and land use, from design and construction to leasing and management, and from financing to foreclosures. The team learns its clients' businesses and acts as an integrated part of their teams, and provides creative, sensible and effective representation tailored to each client's unique needs. With offices in Philadelphia, Harrisburg and Norristown, Pennsylvania, and Cherry Hill, New Jersey, Hangley Aronchick offers a suite of diverse legal services, including litigation, insurance coverage, business and corporate, real estate, bankruptcy, education, environmental, family law, and tax and estate planning services.

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