A&M INSIGHTS

Exiting COVID: how to maximise value from the landlord negotiation and bring certainty to your business

Background

Many retailers and consumer facing businesses with leasehold portfolios did not pay rent in full in the period since March 2020 when the pandemic began. The British Retail Consortium (BRC) reported in May 2021 that two-thirds of retailers in the U.K. are at risk of legal action on at least one of their stores, once the ban on evictions and debt collection from commercial tenants is lifted.

Whilst in some cases rent was formally abated or forgiven, generally it was either deferred without schedule or not paid (relying on COVID protections against non-payment and directors' duties). The British Property Federation (BPF) estimates that by the 30 June 2021, £7.5 billion of commercial rent was in arrears. Whilst many agreements between landlord and tenant have been reached since then, recent survey data from the British Property Federation estimates that 20% of COVID related rent arrears remain unpaid.

In that same COVID period, business models reacted quickly to seek replacement revenues primarily through enhancing digital investment enabling a rapid pivot to delivery and takeaway. Further, footfall trends are still being understood, particularly in respect of city centre locations reliant on office workers for their custom and whose long-term hybrid working trends are not yet fully established. A July 2021 survey by CBI Economics showed 93% of U.K. firms planned to adopt a hybrid working model.

> Companies need to act now to negotiate their COVID lease liabilities with their landlords to bring certainty to strategic decision making, clarity to business capitalisation, and to obtain the best outcome from landlord negotiations that will be required by March 2022.

Companies now face the following three key challenges:

01 Significant unpaid historical lease liabilities with a "cliff edge" legal exposure in March 2022 when COVID non-payment protections drop away for unprotected periods.

02 The need to optimise leasehold portfolio to recognise shifting site performance splits, post-pandemic.

03 Uncertainty over future cash flows given changing portfolio performance mix with a need in future periods to service historical lease liabilities in addition to other financial debts.

What is the legal position?

On 9th November 2021, the government published a revised code of conduct for commercial property relationships, alongside a draft legal bill expected to become law on 25th March 2022.

Until then, tenants will be protected by existing COVID protections that prevent landlords from presenting winding up petitions or seeking tenant eviction for non-payment.

Key facets of the government guidance are:

- Tenants that are able to pay rent debt for any periods, should, regardless of the impact of restrictions on the business during the COVID period; and
- Tenants that are unable to pay rent debts should seek to negotiate with their landlord with an expectation of burden sharing (based on affordability).

If an agreement is not possible between landlord and tenant, a government arbitration process has been announced that:

- Covers rent related to periods of restriction only ("protected rent" periods);
- Is only available to those that would be otherwise viable following an arbitration agreement;
- Will have at its heart the concept of affordability (any protected rent debt should be repaid by tenants if affordable) and viability (the tenant must be viable, notwithstanding protected period rent debt); and
- Has an arbitration application window open for six months post 25th March 2022.

The arbitration process is therefore quite narrow in scope and tenants will need to be clear whether they qualify for the regime ahead of their landlord negotiations.

Alongside affordability and viability, the definition of the protected period rent debt will be at the heart of those negotiations as the starting liability to be negotiated needs to be defined.

> Our view is therefore that given the arbitration regime covers only a narrow subset of businesses (those that would otherwise be viable) and debts (just protected debts), the "deadline" of the 25th March 2022 for the end of the current protections is real and tenants will need to act now to negotiate on their outstanding leasehold debts.

Prepare for the leasehold discussion

Analyse and stratify portfolio performance

Design optimal portfolio based on long-term company strategy

Define protected period liabilities (i.e. what debts were incurred during times of restrictions)

Assess operating cash flow available to service protected period rent, other rent liabilities and ongoing lease and financial debt

Consider funding availability and headroom for investment

Consider affordability

Create proposal

Create negotiation plan and stakeholder communication plan

Execute

In substance this is a debt negotiation

In the absence of a landlord waiver, by March 2022, either consensually or following arbitration, companies will need to have agreed a schedule of payments for their historical leasehold liabilities incurred during the pandemic, that are not eligible for the arbitration regime. Given ongoing commitments to ordinary course lease and financial debt payments, the ending of furlough in September 2021 and increased requirement for working capital investment post-reopening, this presents a significant liquidity risk.

It is therefore crucial that companies and their boards understand their ability to service negotiated leasehold debts. The negotiation is akin to a straight financial debt negotiation and will be based on a negotiated lease liability "write-off" (based on the core concept of affordability) alongside a rescheduling of remaining payments, potentially with an interest element. Any write-off of leasehold debt could create taxable gains, with no guarantee that past losses could offset this. Careful tax planning is therefore needed to mitigate the risk of a "dry tax charge" whereby a tax cash payment is required on the basis of a non-cash profit.

During landlord/tenant negotiations, considering the impact of discussions on other stakeholders is important and communication transparency is essential. The most obvious example is the impact that lease rescheduling will have on the ability to service financial debts; and whether such stakeholders need to be brought into discussions and communicated with from the outset. Importantly, contagion impacts need to be actively managed for what may start as a leasehold discussion could end as a wider debt negotiation if the risk of cross default into other financial obligations is not managed.

> Where the performance of a leasehold portfolio has shifted during the pandemic (whether through a higher long-term weighting of online fulfilment or through changing footfall patterns), optimising the portfolio for the future will also be a key management concern.

If this is a discussion that is needed imminently, it may be beneficial to combine this discussion with the COVID liability negotiation to avoid the detrimental effect of a "salami-slicing" negotiation and ensure the negotiation allows for a long-term solution.

Ultimately, any negotiated or arbitrated agreement with landlords may require creative risk sharing solutions if affordability is a concern. In such circumstances where payment is conditional on performance (e.g. turnover rent / equity stake / "pay if you can" with bullet), we would expect landlords to require access to (and ability to diligence) business plans and cash flow forecasts as the basis for discussion; a feature that points to this discussion being in line with traditional lender negotiations.

If the business is eligible for the arbitration regime opening up the books is a requirement for the arbitrator's decision.

How can companies maximise their benefits from negotiations and what happens if agreement cannot be reached?

While negotiations may be in good faith there is a risk that companies could face insolvency if a significant compromise cannot be agreed with landlords.

In that situation, it is essential that management prepares a Plan B for circumstances where discussions and/or arbitration fails. Recently, a Plan B for U.K. leasehold discussions has most often been in the form of a Company Voluntary Arrangement (CVA) that seeks to reorganise unsecured debts. However, recent precedent shows that a U.K. Restructuring Plan (RP) can provide an alternative mechanism to implement a leasehold restructuring (as was first seen on the Virgin Active Restructuring Plan).

The features of these procedures are not the focus of this article, but provide significant precedent for use as a Plan B.

Preparation for a Plan B in parallel with ordinary course leasehold discussions has 2 key benefits:

01 Provides a credible alternative that gives maximum leverage to the company in the landlord discussion and importantly sets a baseline from which to negotiate.

02 Protects directors and the company with a fall back if talks fail; preparation importantly demonstrates that directors have explored all available options to restructure their commitments.

Acting now is beneficial to the company and the landlord

With signs that the worst of the pandemic is behind us, and as the economy is now largely open we recommend that companies prepare for leasehold discussions today. The benefits of acting now are multiple:

Bring certainty to the business – understand your future cash flows to give clarity to post pandemic investment and business strategy as well as to lenders and equity investors.

The early bird catches the worm – reaching early agreement provides cash flow to landlords who may look favourably on companies that engage constructively, and quickly. The most beneficial solution is likely to arise from well thought through negotiations rather than those that are driven up against a hard deadline. Our experience of discussions with landlords during the pandemic is that earlier and more open conversations have often led to improvements in the long-term landlord relationship.

Arbitration outcomes are better if it follows failed good faith negotiations – any arbitration service will likely look more kindly upon companies that have made concerted attempts to come to agreement pre-March 2022.

How can A&M help?

A&M can assist you extract the best outcome for your business in leasehold discussions through development of plans that will best prepare you for your landlord discussions. We have significant experience of:

- Designing optimal leasehold portfolio structures considering both the current situation of the business and its long-term strategy
- Tactics for accessing the arbitration regime, if required
- Assisting in considering need for creative leasehold solutions including turnover based rent (and footfall/ concession related rents), equity landlord positions and "pay if you can" agreements
- Preparation of detailed business plan and cash flow forecasts that form the basis of landlord negotiations
- Assessing impact on and lead discussions and communications with a range of stakeholders in parallel to the landlord discussion
- Providing contingency support as Plan B leverage to negotiations and a fall back if consensual negotiation or arbitration cannot find an affordable solution:
  - CVA
  - Restructuring Plan
  - Administration (incuding pre-pack)

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KEY CONTACTS

Richard Fleming
Managing Director
London
+44 777 093 1706
rfleming@alvarezandmarsal.com

Erin Brookes
Managing Director
London
+44 782 353 3676
ebrookes@alvarezandmarsal.com

Mike Corner-Jones
Managing Director
London
+44 207 663 0439
mcorner-jones@alvarezandmarsal.com

Mark Firmin
Managing Director
London
+44 780 190 1133
mfirmin@alavrezandmarsal.com

Ed Manning
Senior Director
London
+44 746 985 4464
emanning@alvarezandmarsal.com

Mark Stevenson
Senior Director
London
+44 779 694 0966
mstevenson@alvarezandmarsal.com

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