SMALL BUSINESS COMMERCIAL LEASE RENEGOTIATION STRATEGIES FOR POST-PANDEMIC CASH FLOW SUSTAINABILITY AND RISK MITIGATION

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ABSTRACT

The COVID-19 pandemic-induced global lockdowns of populations and businesses have resulted in significant declines in in-store consumer spending. This has created an impairment of net cash inflows for many retail businesses, especially small businesses and entrepreneurial ventures where net margins are thin. These lockdowns likewise have adversely impacted small business cash flows throughout local and global supply chains. Many of these companies have been able to reduce variable costs, but fixed costs remain. In an October 2020, Alignable Pulse Poll of 7,726 tenant small-business owners, 34% of the respondents indicated that they may be unable to pay their rents, representing one of their primary, contractual, and long-term fixed costs. State and local governments in 32 out of 50 states have provided eviction protections for commercial tenants, as have the governments in the U.K., Germany, Canada, and Mexico, among others, but those protections are limited and short-term. Small business owners are no longer able to ignore low-likelihood, high-risk events. They now need to implement financial management best practices that are critical to business resilience and sustainability, considering the COVID-19 re-shaping of the issues they will face in the near- and long-term future. This paper presents small business tenants' risk-mitigation negotiating strategies in renegotiating existing commercial space leases, focusing on lease-based cash management. Using an integrative-collaborative negotiating approach, small business owners, often finding themselves at a leverage disadvantage, can utilize key negotiating skills in developing an effective strategy in renegotiating lease terms with landlords. This study provides win-win, integrative strategies for commercial lease provisions related to the following: rent scheduling; use, assignment, and subletting clauses; relocation and cancellation clauses; payment currency; percentage rent provisions; and the leverage implications of the use of the legal doctrines of force majeure, impossibility, and frustration of purpose in negotiating commercial leases.

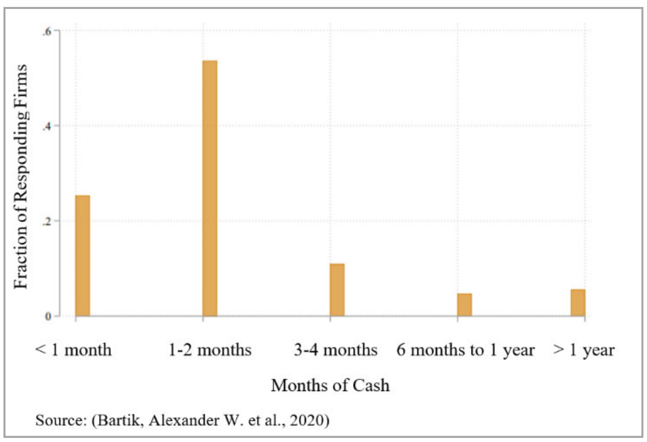
Keywords: COVID-19 pandemic, commercial lease, valuation, negotiation, cashflow

INTRODUCTION

Global population and business lockdowns to control and ultimately curb the Coronavirus (COVID-19) pandemic have significantly and adversely impacted in-store consumer spending, creating an impairment of net cash inflows for retail businesses, especially small businesses where net profit margins are thin. Similar cash flow pressures exist in small businesses throughout local and global supply chains (Juergensen, Guimón, & Narula, 2020).

A survey conducted by the National Bureau of Economic Research between March 28 and April 4, 2020, showed the fragility of U.S. small business cash positions in the early stages of the Covid-19 pandemic health crisis. From a sample size of more than 5,800 small businesses surveyed, with over 82% having less than 9 employees (and all having less than 500 employees), nearly one-fourth had a cash balance covering less than one month of expenses, with one-half having just enough cash to meet one-to-two months of expenses (Figure 1).

FIGURE 1
Histogram of Approximate Months of Cash Available (N=4,184)



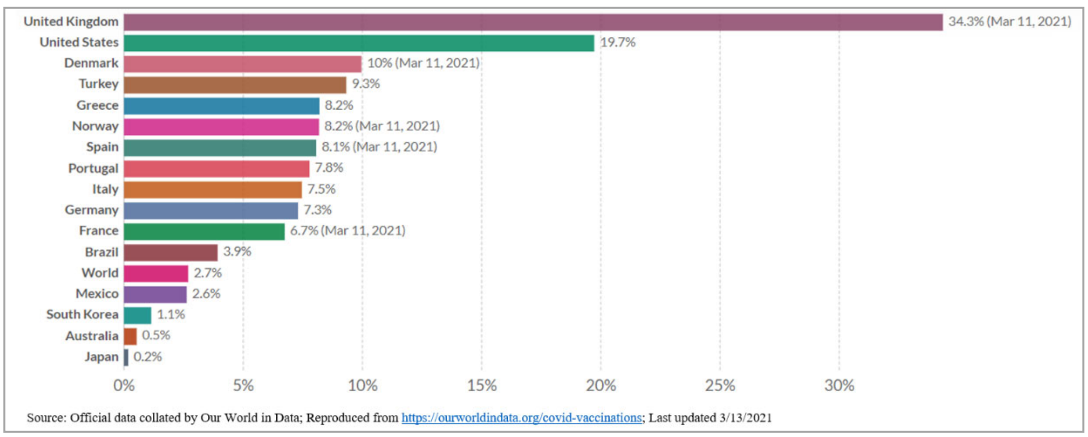
Source: Bartik et al. (2020).

In an October 2020 Alignable Pulse Poll (Alignable Research Center, 2020) of 7,726 U.S. tenant small business owners, 34% of the respondents indicated that they may be unable to pay their rent, one of their primary, contractual, and long-term fixed costs. State and local governments in 32 of 50 states have provided eviction protections for commercial tenants, as have the governments in the U.K., Germany, Canada, and Mexico, among others, but they are short-term and limited.

Research shows that small business owners and founder-manager entrepreneurs (Brown, 2017), especially nascent entrepreneurs (Forbes, 2005), tend to be more optimistic than either non-founder managers or those employed by small- and medium-sized enterprises (SMEs) and entrepreneurial ventures. This optimism may lead to the expectation of a short-term economic impact from the pandemic.

However, counterbalancing this optimism are three areas of uncertainty for small businesses: delayed and uneven Covid-19 vaccinations, the continued emergence of Covid-19 virus variants, and an uncertain post-pandemic consumer psychology. Regarding vaccinations, the first dose of the Covid-19 vaccine was administered in the U.S. on December 14, 2020. As shown in Figure 2, most of the world is slow to vaccinate due to shortages, especially in Europe, and due to resistance to belief in the efficacy and/or relatively harmless side-effects of the vaccine. Most health experts believe that a return to economic normalcy will occur only when herd immunity is reached. Yet, to date, the World Health Organization (WHO) has not released the percentage of the population that needs to be vaccinated to achieve herd immunity. The global management consulting firm, McKinsey & Company (2021), has identified six possible risks challenging a rapid global delivery of Covid-19 vaccines: raw-material constraints in production scaling; quality-assurance challenges in manufacturing; cold-chain logistics and storage-management challenges; increased labor requirements; wastage at points of care; and IT challenges (Agrawal, Azmi, Heller, Kumar, Mysore, Patel, Sabow, Singhal, & Truesdale, 2021).

FIGURE 2
Share of Total Country Population That Received At Least One Vaccine Dose



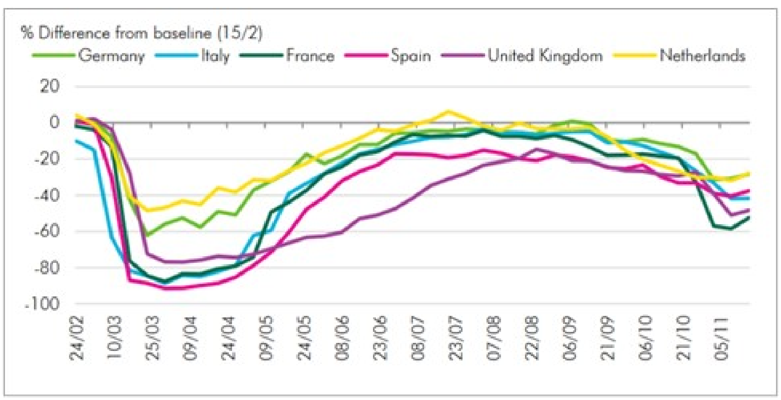
Source: Our World in Data (2021).
Note: May not be fully vaccinated if multiple doses required; 2/12/2021 data unless otherwise noted.

Even if the pace of global vaccinations accelerates, concern exists that the economic impact of the Covid-19 health crisis may persist long-term. In their 2021 annual letter, Bill and Melinda Gates predicted that within the coming year, only one in five people in low- and middle-income countries will be able to receive Covid-19 vaccinations (Gates, 2021). This forebodes a long-term pandemic-induced economic impact. A recent study by the International Chamber of Commerce shows that uneven global concentrations of vaccinations will disrupt international supply chains to result in global losses in the $1.5 to $9 billion range--half of which will occur in the world's richest countries (ICC-International Chamber of Commerce, 2021).

Another uncertainty complicating a short-term economic disruption is whether existing vaccines can immunize against emerging virus variants and, if not, whether researchers are able to keep pace by creating new or booster vaccines (Su, Wang, & Jiang, 2021). In the early stages of the pandemic, researchers detected signs of Covid-19 virus mutations (Vankadari, 2020), with unclear implications. But vaccine developers focused on the initial form of the Covid-19 virus as its target, with Pfizer-BioNTech, Moderna, and Johnson & Johnson having vaccine-development successes in early 2021 after a year of R&D efforts. Soon after the vaccine approvals, scientists continued to find Covid-19 virus variants (Chen, Li, Wu, Geng, & Mao, 2021). Keeping pace with the discovery of these variants has been challenging (Williams & Burgers, 2021), with some applying advanced technologies, including artificial intelligence techniques (Garvin, Prates, Pavicic, Jones, Amos, Geiger, Shah, Streich, Gazolla, & Kainer, 2020).

The third uncertainty facing small business owners is whether the pandemic-related change in consumer psychology will be temporary or have impactful permanency. During the pandemic, state and local governments in 92 countries ordered lockdowns to control population behavior, resulting in a dramatic consumer shift from in-store to online buying. Many of those lockdowns lasted months, with some countries having multiple lockdowns. CBRE EMEA research (CBRE, 2021) shows the cyclical impact of government-mandated lockdowns on retail and leisure mobility in selected European countries (see Figure 3). The consequences are revealed in the CBRE EMEA forecasts: commercial vacancy rates in Europe are expected to continue to rise to a high in Q2 2022, with commercial rents declining to a low in Q1 2022 and returning to pre-pandemic levels only in 2025. Permanent shifts to continued remote work environments may delay recoveries.

FIGURE 3
Retail and Leisure Mobility: Select European Countries



Source: CBRE (2021).

Although the lockdowns have been a factor in modifying consumer behavior and will have both short- and long-term consequences, research is revealing that the major impact on consumer demand is on consumer psychology, with one study showing that out of an overall 60% drop in consumer traffic, only seven percentage points of that drop was a result of legal restrictions (Goolsbee & Syverson, 2020). Fear of infection was the major factor driving the decline in consumer traffic, and it started before lockdowns were mandated.

The following sections provide insights and strategies for small business owners to mitigate lease-based cash flow impairment risks.

ADDRESSING THE BURDEN OF FIXED CASH FLOWS

Many small business owners facing the adverse economic conditions brought by the Covid-19 pandemic are in positive cash balance survival mode. To address the in-store consumer spending disruption, small-business owners have been able to reduce variable costs, mostly through reductions in product-related purchases, limited employee hours, or outright layoffs. Yet, fixed cash flows, normally large and contractual, remain. The legal and financial implications of not meeting those fixed cash flow obligations are significant. For many small business owners, lease rent is their major, contractual fixed cost, with leases committing lessees to a commercial space for multiple years.

For the analysis that follows, it is assumed that the lessor and lessee are gain-seeking and risk averse, that their commercial leases are legally binding contracts that define the terms of space occupancy, and that the lease was signed without the existence of enforceable breach-of-contract defenses by either party, such as agreement under fraud, mistake, misrepresentation, duress, undue influence, incapacity, unconscionability, or incapacity (Perillo & Calamari, 2009).

The following sections explore three potential sources of lease contract relief: common law doctrines, existing contract clauses, and renegotiation of the terms of the existing lease contract. The following question is at the core of these areas of relief: Could small business owners have anticipated the possibility of a Covid-19-type pandemic and its global impact at the macroeconomic and microeconomic levels and have negotiated sufficient risk mitigation clauses into their leases?

It is worth considering that since the H1N1 virus (February 1918 to April 1920) infected a third of the world's population, causing between 20 and 50 million virus-related deaths, there have been six pandemics: H2N2 (1957-58), H3N2 (1968), SARS-CoV-1 (2002-2004), A/H1N1 (2009), Western African Ebola (2013–2016), MERS-CoV (2014). Only the H2N2 and H3N3 pandemics resulted in more than 100,000 deaths worldwide and none brought the high level of death rates, global lockdowns, and economic disruptions as did the Covid-19 pandemic.

At the time of the negotiation leading to the original lease terms, assuming that the commercial lease negotiation and agreement took place prior to the Covid-19 pandemic, a small business owner's construal of their business environment, current and future, likely included their consideration of unanticipated and normal course-of-business conditions and risks. However, it is unlikely that the lessor and lessee anticipated a Covid-19-like pandemic and its impact, even considering the seven pandemics that occurred in the last 103 years, with only one of them being a serious killer.

Not anticipating and mitigating the risks of a pandemic with once-in-a-hundred-years impact is both reasonable and aligned with Simon's bounded rationality theory (Simon, 1955, 1990) that the reliance, by economic and management theories, on a perfectly rational human being (*homo economicus*) having access to perfect information that always leads to an optimal decision is misleading in its depiction of real-world decision-making. The information a small business owner/lessee accesses as relevant in preparing for, and engaging in, a lease negotiation is bounded by that decision-maker's perceived environment at the time of the decision (Cristofaro, 2017).

Elevating the challenge facing small business owners/lessees in their lease negotiations is the likelihood that their respective bounded information sets may be asymmetric (Bazerman & Chugh, 2006), possibly due to differences in willingness or ability to expend time and resources in acquiring information (Kreps, 1990). Asymmetric information sets are likely to result from the commercial space market being the primary market in which lessors apply their business model, while lessees deal in that market only sporadically and on an as-needed basis. Lessees and lessors might also use different heuristics—cognitive (Bazerman & Moore, 2012) and/or judgmental—that would lead to less-than-optimal decisions by either or both parties.

RELIEF THROUGH COMMON LAW DOCTRINES

Globally, common law doctrines support the obligation of all parties to a contract to honor the promised performance specified in the terms of a contract. This is a key leverage point for either party, as there is a strong legal standard for courts to enforce performance or secure restitution for damages from non-performance. In the United States, this standard is not codified as a specific law, but implied as a good faith performance obligation (Markovits, 2014).

Internationally, good faith performance on contracts is enforced under a more formal *pacta sunt servanda* doctrine (Latin: agreements must be kept) originating in the 13th century CE (Gamer, 2004; Hyland, 1993). For example, the current German Civil Law Code (2020), *Bürgerliches Gesetzbuch* (Gesetzbuch, 2020), provides the guidance: “By virtue of the debt relationship, the obligee is entitled to demand performance from the debtor,” with debt being used in a generalized context meaning any legal obligation of contract performance. Other countries, e.g., Brazil (Filho, 2013), France (Article 1134), and Portugal (Article 227), have followed the good faith concept embodied in the *pacta sunt servanda* doctrine found in the civil code of Germany (Section 241). The Chinese Civil Code (CCL, Article 8) also addresses good faith as a binding duty to perform on a contract and its implication of honesty and trustworthiness extends through pre-contract negotiations, the formation of the contract, and performance according to the terms of the contract (Hsu, 2007).

Although the common law doctrine of good faith binds parties to performance, common law also allows legal modifications or total relief from performance on contracts without either party having to rely on one or more clauses therein. Attaining relief, however, creates legal costs, and the legal standards required to prove that the conditions allowing relief are high.

The common law doctrine of impossibility allows relief on proof that, because of changed circumstances such as a force majeure event or new legislation, performance on the contract becomes objectively impossible (Benoliel, 2020). Force majeure, often found cited specifically in commercial leases, refers to an extraordinary event, characterized as an Act of God, that is unforeseeable and unavoidable, and that frees the parties to the contract from their duty to perform. Impracticability is a related and somewhat relaxed version of the doctrine of impossibility in that it requires only that the difficulty of performance be significant enough to render that performance impractical, although not impossible (Wright, 2004). The doctrine of frustration of purpose relates to an event occurring such that, if the parties to the contract had known of the event prior to the signing of the contract, both parties would have deemed the purpose of the contract unrealistic. These U.S. common law doctrines, with some differences at the state level, require that the events justifying the relief were unforeseeable and beyond the parties' control at the time of signing the contract.

RELIEF THROUGH CONTRACT CLAUSES

Lease contracts may include clauses that parties to the contract can exercise for relief. Although most commercial leases will have a force majeure clause, because of the lack of sustained and adverse economic impacts resulting from pandemics after that of 1918, the clause will likely not include a viral pandemic as a force majeure event. However, it may include the adverse economic impact resulting from government mandates, such as lockdowns. Force majeure clauses typically apply to relief of actions by the parties to the contract but not to the financial obligations of each party created by the terms of the contract.

Lease downsizing clauses offer some cashflow remedy to the small business owner, but these clauses have minimum space limitations. Moreover, downsizing may not be the objective of the small-business owner navigating through the pandemic, as the eventual upsizing space to get back to normal may not be available at the same or another preferred location.

Lease cancellation clauses (or contract break options for the lessee) allow either party, under limiting conditions, to be relieved of contract performance. These clauses typically come with an earliest termination date prior to the end of the lease term that may not be aligned with the timing of the small business owner ceasing operations and waiting out the pandemic without a cashflow burden.

These relief clauses come with a cost. Lessors will charge higher base rents for taking on the risk of the inclusion of downsizing and lessor-friendly cancellation clauses in a lease (Vimpari, 2018), so these clauses may be expensive for the small-business owner.

RELIEF THROUGH RENEGOTIATION (REGEARING)

The small-business owner will likely face lessor resistance in attempting to renegotiate a lease, especially to lower rent. Renegotiating (also called regearing) the terms of an existing lease contract brings into play the power and leverage dynamics of the lessor and lessee.

The Process Frame

Negotiating style, or process frame, has an impact on negotiating outcome. Although there are variations, most professional negotiators have an integrative-collaborative process frame or a distributive-competitive process frame (Griessmair & Druckman, 2018).

A distributive-competitive process frame, also called a win-lose, zero-sum, or claiming value style, is one in which the negotiator sees a fixed "pie" of value and sets out to get as much of that pie as possible. For some small-business owners, this process frame is easy to adopt as their continued viability in their marketplace is based upon fierce win/lose sales competition. This competitive mind-set can carry over into all deal-making, including a lease negotiation and, potentially, a lease renegotiation. For a small-businessperson, an "I need to win to survive, therefore, you need to lose" mindset and strategic approach to each negotiation is a misplaced survival-mentality frame.

An integrative-collaborative process frame is most often associated with what is also called "win/win bargaining" or "interest-based bargaining." Integrative bargaining, with its potential for expansion of that "pie" of value in a negotiation, is most powerful in multi-issue negotiations, where strategic concession trade-offs are possible. This process frame typically leads to win/win agreements of value for all parties (Bazerman, Magliozzi, & Neale, 1985).

The Internal Frame

Frames can take other forms during a negotiation, and the ability to create and articulate frames within a negotiation is an effective and powerful skill. Frames can be internal or external. Internal frames are characterized as a negotiator's *frames of mind*, for example, the mental representations of the issues at stake in the negotiation, the objectives set for the negotiation, the positions taken during the negotiation, and the consideration of the interests of the other parties in the negotiation.

An important internal frame is the perception by the small-business owner of the leverage they bring to a negotiation. Leverage has been categorized as positive, negative, and normative (Shell, 2006) and, among many definitions in the literature, defined as "power rooted in consequences" (Kirgis, 2014). Positive leverage exists when each party has something the other party wants, such as space to rent by the lessor, and a high-quality tenant by the lessee. Negative leverage is harm-based, where one party can harm the other party and the focus of the negotiation is to prevent that harm. Normative leverage relies on standards or norms, e.g., market data or laws, to support negotiating positions.

Power dynamics in complex negotiations are especially challenging for entrepreneurs and small-business owners, where skills in managing financial, human, and information resources rather than negotiating are most critical to day-to-day small business and entrepreneurial problem-solving and, ultimately, survival (Aikens & Peterson, 2017).

The power of leverage brought to a negotiation is as much perception as reality. Small business owners and entrepreneurs often underestimate their leverage, especially when negotiating with larger organizations. They identify with small professional and social groups (Powell & Baker, 2014). They often interact with much larger customers, customer groups, and supply chain counterparts, with relative size often measured as number of employees, sales and profits, and financial resources, among others. Size differentials are often conflated with status, further reinforcing small business power inferiority (Castellucci & Ertug, 2010). This self-perception of disadvantageous relative size and power is subjective, based more on psychological experience than the real business dynamics in play in any business negotiation (Vignoles, Regalia, Manzi, Golledge, & Scabini, 2006).

Self-perception is dynamic and based on the spectrum of the routine and often stressful activities within the organization (Coupland & Brown, 2012). It evolves through the experience of leading a company through its life-stage events--these include achieving profitability, acquiring key customers, R&D successes, and securing professional funding (Tripathi, Zhu, Jacob, Frese, & Gielnik, 2020). Small-business owners can use these positive events to evoke the self-identity confidence (Cardon, Gregoire, Stevens, & Patel, 2013) that will drive success in renegotiating their leases.

The External Frame and Norm of Reciprocity

External frames are how negotiators present their mental frames and positions on issues, verbally, in writing, and with body language, to their counterparts in the negotiation (Carnevale, 2008). These frames have a powerful influence on acceptances of positions and willingness to make concessions.

Framing is the central thesis of Prospect Theory, the seminal research of Kahneman and Tversky (1979) on the behavioral psychology of how individuals make choices based on whether those choices are framed as a prospective gain or loss. In developing prospect theory, Kahneman and Tversky (1979) found that the critical value drivers for decision-makers are changes in utility rather than final outcomes, that individuals have an asymmetric value perspective on gains and losses ("losses loom larger than gains"), and that an individual's utility from their choice is based on their expectation of gain or loss from a reference point.

Insights drawn from Prospect Theory provide guidance to small-business owners in developing a flexible lease renegotiation strategy as well as a sustainable strategy for future negotiations. The small-business owner will likely be negotiating with a lessor who is subject to some degree of status quo bias toward the current terms of an existing legally-binding lease, their reference point. Any change in those terms will be perceived by the lessor as creating the risk that the revised terms will result in a loss to the lessor relative to the original terms. The small-business owner can frame the renegotiated terms of the lease as a long-term gain for the lessee, as represented by an increase in their property value through an exchange of concessions.

The integrative-collaborative negotiating process moves forward, relying on the norm of reciprocity as it relates to concession-making (Mislin, Boumgarden, Jang, & Bottom, 2015). One party offering a concession on one issue expects a reciprocal concession offer from their negotiating counterpart on another issue. These exchanges can create value. For example, on Issue X, Negotiator A gives a concession that is of low cost to them but of high value to Negotiator B, while on Issue Y, Negotiator B gives a concession that is low cost to them but of high value to Negotiator A. That exchange creates value that would not have been created without the reciprocal concessions.

If a lessor offers a concession to the lessee on a short-term reduction in rent to sustain the lessee's business during pandemic-related business disruption, the lessor will expect a reciprocal concession of value from the lessee. Areas of reciprocal lessee concession-making comprise more restrictive terms of the lease cancellation clause, the use, subletting, and assignment clause, the relocation clause, and the tenant improvement allowance, with the lessor agreeing to refund to the lessor a portion of that allowance at the end of the lease term. None of these concessions would adversely impact lessee short-term cashflow. If the lessor/lessee relationship is international in nature and the rent payment is in the lessee's national currency, cash payments from the lessee to the lessor can be shifted to the lessor's national currency to alleviate the lessor's exchange rate risk.

Rent increases during the lease are contractual and are an important element in forecasting the lessor cash flows that are used in leased property valuation models (covered below). Slight increases in these growth rates can provide a value-based concession for lessors.

Percentage rent clauses are often included in retail space leases and can be a critical lessor-valued concession by lessees. With this clause, a percent rent is added to the lease base rent after an annual revenue breakpoint is reached. For example, if a lease base rent is $1,000 per month and the percentage rent is set at 6%, then the natural breakpoint above which the percent rent is added to the base rent is calculated as ($1,000 x 12) / 0.06 = $200,000. During each annual term of the lease, if the lessee's revenue exceeds $200,000, a percent rent of 6% of the excess revenue will be added to the annual base rent.

Small business owners, focused on conserving cash during the pandemic-related business disruption, during which time revenues likely will have remained or dropped below that natural breakpoint, could offer a percentage rate concession to, say, 6.5%. This would lower the natural breakpoint to $184, 615 [($1,000 x 12)/0.065] with the percent rent at 6.5% of the annual excess. The small business owner may be willing to accept higher percent rents in the future in exchange for lower short-term rents during its pandemic-related survival stage.

Commercial Lease Valuation Models

A critical interest of the landlord is to increase, or at least maintain, the value of the leased property. That value is embodied in the discounted net cash flows to the lessor which includes the base rent net of any expenses paid by the lessor depending on the type of lease: gross, modified gross, or net. Incentives provided by the lessor to the lessee also provide value (Jefferies, 1994). They could include the initial month's free of rent, a tenant improvement allowance, rent capping, and a put option on additional space. Those values are reflected in upward adjustments by the lessor in base rents.

Each individual lease has its own risk-and-return characteristics, as does the lease portfolios of multi-tenant properties. Those values are represented by the conventional discounted cashflow (DCF) valuation model which can be used by both tenants and landlords. Various lease and lease property DCF valuation models have emerged over the years with varying perspectives on how to represent return and risk in the model: Real Value (Wood, 1986); Equated Yield (Marshall, 1976); Real Value Hybrid (Crosby, 1986a; Crosby, 1986b); Rational (McIntosh & Sykes, 1983); and Modified Rational (Baum & Shi Ming, 1985a; Baum & Shi Ming, 1985b).

Mandell (2002) uses a discounted perpetual cash payments approach in valuing the property asset, with the assumption that net cash inflows will exist in perpetuity (Equation 1). Mandell noted that the model was first introduced by Brown in an unpublished case and then applied by Brown (1995) to rental market incentives.

$$V_0^{LP} = \left(R_0^{LP}\ \frac{1-(1+r_L)^{-p}}{r_{LP}}\right) + \frac{R_0^{LP}(1+g_1^{LP})^p}{(1+r_{LP})^p}\left(\frac{1-(1+r_{LP})^{-p}}{r_{LP}}\right)$$
$$+ \frac{R_0^{LP}(1+g_2^{LP})^{2p}}{(1+r_{LP})^{2p}}\left(\frac{1-(1+r_{LP})^{-p}}{r_{LP}}\right) + \ldots \to \infty \qquad (1)$$

subject to (1) both $r_{LP} > g_n^{LP}$ for all lease portfolios and all lease periods and (2) the information set available at t = 0, and where

V_0^{LP} = current value to lessor of lease portfolio, LP,
R_0^{LP} = rent-based net cash flow in the current time period 0 for lease portfolio, LP,
p = period (number of years) of fixed rent,
g_t^{LP} = expected property value-based growth rate of rent from p_n to p_{n+1},
n = number of leases in the lessor's lease portfolio,
r_{LP} = is the rate of return (capitalization rate), which includes the lessor's weighted average cost of capital and a diversified lessees-related risk premium that is expected to be generated on the property's lease portfolio

This "ground rent" model can easily be modified to value a specific lease of a finite period, as shown in Equation 2.

$$V_0^{L} = \left(R_0^{L}\ \frac{1-(1+r_L)^{-p}}{r_L}\right) + \frac{R_0^{L}(1+g_1^{L})^p}{(1+r_L)^p}\left(\frac{1-(1+r_L)^{-p}}{r_L}\right) + \frac{R_0^{L}(1+g_2^{L})^{2p}}{(1+r_L)^{2p}}\left(\frac{1-(1+r_L)^{-p}}{r_L}\right) + \ldots$$
$$+ \frac{R_0^{L}(1+g_n^{L})^{np}}{(1+r_L)^{np}}\left(\frac{1-(1+r_L)^{-p}}{r_L}\right) \qquad (2)$$

where

V_0^{L} = current value to lessor of lease, L,
R_0^{L} = tenant rent in the current time period 0 for lease L,
p = period (number of years) of fixed rent,
g_t^{L} = expected growth rate of rent from p_n to p_{n+1},
n = period number in which the expected rent growth rate is applied,
r_L = is the rate of return (capitalization rate), which includes a lessee-related risk premium

As both valuation equations show, a renegotiation that results in a short-term reduction in rent with a capitalized (compounded) recovery in the years following the reduction will have a slight adverse impact on the value of the lease to the lessor, but clearly not as much as a permanent rent reduction with its associated perfect value elasticity. Although a permanent rent reduction would be preferable for the lessee, that resolution would not be aligned with the purpose of the reduction, which is riding out the (hopefully) short-term pandemic-induced cashflow impairment for the small business lessor.

A permanent rent reduction would also be clearly at odds with the value-based interests of the lessor unless the lessor receives some concessions on other lease provisions that would reduce the risk of the lease to the lessor, as noted above. A reduction of the risk would result in a lower discount rate used in the lease valuation, thereby potentially offsetting the decline in—or possibly even increasing—the property value from the short-term deferral of rent. Small-business owners could negotiate, as part of the short-term rent reduction, a gradual or immediate return to full base rent based on a CDC or state or local government mandate reopening retail businesses for 100% occupancy. This would allow the small-business lessee to emerge from the economic disruption sustainably, which benefits the small-business owner/lessee and the lessor.

Elasticities of Lease Value

To analyze the sensitivities of leased property value to changes in rent terms, the following presents rent growth rate and required rate of return elasticities of lease value. Equation 2 individual lease version is used of the Mandell (2002) model for 6-, 9-, and 12-year terms. The fixed-rent periods or non-review periods are three years, so the 9-year lease would have three fixed-rent periods, with the rent during the first three-year fixed rent period being the initial rent R_0, and the rents during the next two fixed-rent periods being $R_0(1+g)$ and $R_0(1+g)^2$, respectively. Rent growth rates are assumed to be constant throughout the lease, but the model can easily be used for non-constant growth rates, matching then-current market conditions.

An OLS estimation of value elasticities is used here after natural log conversions of both independent and dependent variables. The general form of the estimated equation, using lease value, V, as the Y value, and rent growth rate, g, as the X value, is:

$$ln\mathrm{V} = a + b\,ln g, \tag{3}$$

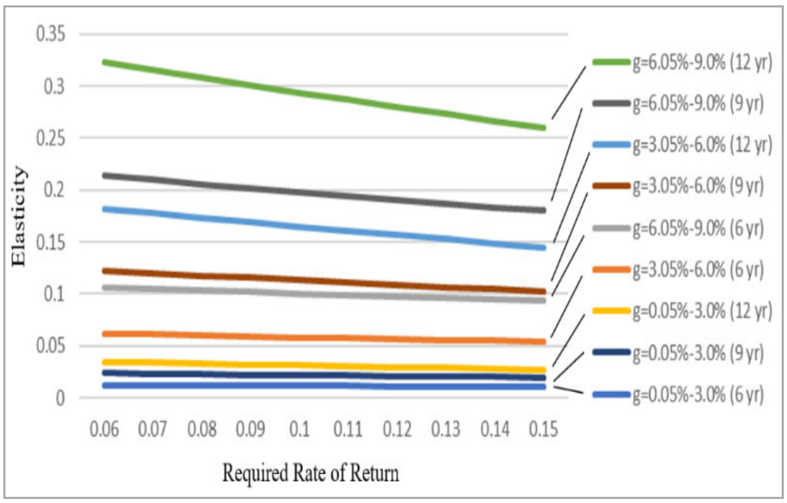
where 'a' is the intercept of the characteristic line and 'b' is the slope or, in the context of this analysis, the elasticity coefficient, which can be directly estimated, as demonstrated by differentiating the estimation equation as follows:

$$d(ln\mathrm{V}) = b\, d(ln g) \rightarrow \frac{1}{V} d\mathrm{V} = b \frac{1}{g} dg \rightarrow \frac{dV}{V} = b \frac{dg}{g} \rightarrow b = \frac{dV}{dg} \frac{g}{V} \tag{4}$$

A one percent (1%) change in 'g' results in a 'b' percent (b%) change in V. From the last equality in Eq. 4, the coefficient of elasticity depends on the relationship of the g and V variable. In the context of an OLS estimation, the elasticity varies along the linear characteristic line.

Using Mandell's (2002) lease valuation equation, the results of the rent growth rate elasticity calculations show the expected positive linear relationships, with low inelasticities ($0 < e < 1$) across all estimations (Figure 4). Low rent growth rates show low value elasticities regardless of the lease term. Rent growth rate elasticities of lease value at higher rent growth rates are more responsive to lease term as well as the required rates of return that are used as cashflow discount rates, with rent growth rate elasticities declining slightly at higher required rates of return for given rent growth ranges. Yet, for all estimations, rent growth rate elasticities of lease value were low and in narrow ranges across all variables. A small-business owner renegotiating rent growth rates in a current or upcoming review period can use this information-based leverage: although a reduction in the rent-increase percent will have some adverse impact on the lessor's cash flow, the overall impact on the lease value would be small.

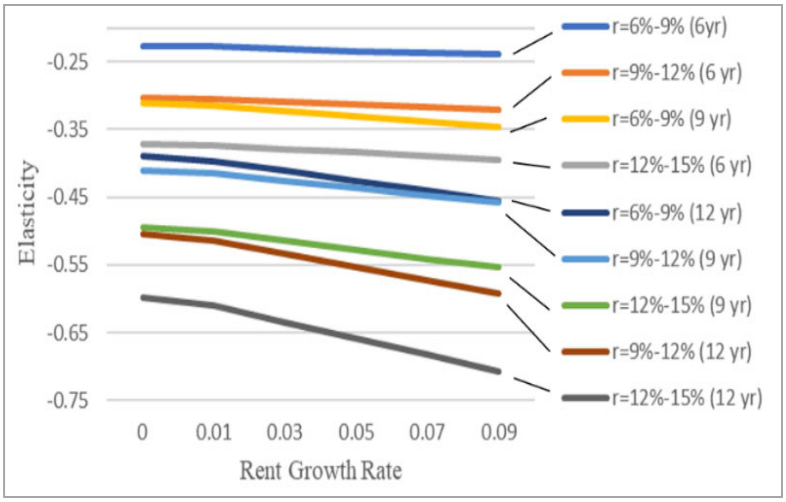
FIGURE 4
Rent Growth Rate Elasticities of Lease Value



[This derivation is based on Mandell's (2002) Lease Valuation Equation.]

Again, using Mandell's (2002) lease valuation equation, Figure 5 shows the required rate of return elasticities of lease value for different ranges of the lessor's required rate of return. The results show that longer-term leases at higher required rates of return have greater negative inelasticities, with sharp increases in those elasticities at higher rent growth rates. Conversely, short-term leases with lower required rates of return, possibly during periods of low interest rates, show low negative inelasticities with elasticity changes occurring only in narrow bands across all rent growth rates.

FIGURE 5
Required Rate of Return Elasticities of Lease Value



[This derivation is based on Mandell's (2002) Lease Valuation Equation.]

Knowing these elasticity patterns provide small-business owners and their landlords with a clearer understanding of the impact on property valuations when renegotiations occur in the context of current interest-rate levels. During periods of low interest rates, as exist currently during the Covid-19 pandemic, small-business owners can frame their temporary rent-reduction position in the context of it having a relatively minor impact on property valuation.

CONCLUSION

The 2020-21 Coronavirus (Covid-19) pandemic has provided ample proof that pandemic diseases are real, recurring, and a constant threat to the survival of small and entrepreneurial businesses. They can be severe enough to cause serious business disruptions with the real potential to inexorably take all businesses, especially small and entrepreneurial businesses, to the very brink of insolvency.

Many small-business owners facing the adverse economic conditions brought on by the Covid-19 pandemic have been in positive cash-balance survival mode. They have managed their variable cash-based costs by downsizing their workforce and reducing expenditures. Managing their fixed, contractual cash rent payments is more challenging. A clear understanding is necessary of common law doctrines guiding performance on lease contracts, with the knowledge and skills required to renegotiate the lease to relieve the lessee's cash flow pressures.

Even on a short-term basis, this will increase the likelihood that small businesses will emerge from the economic disruptions intact. They also will allow small and entrepreneurial companies to craft future leases that are more flexible in addressing the cash flow implications of the *new normal* uncertainties regarding the efficacy of vaccines against virus variants and the pandemic-related changes in consumer spending behavior. This will result in a more sustainable and resilient small business in a more challenging business world.

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