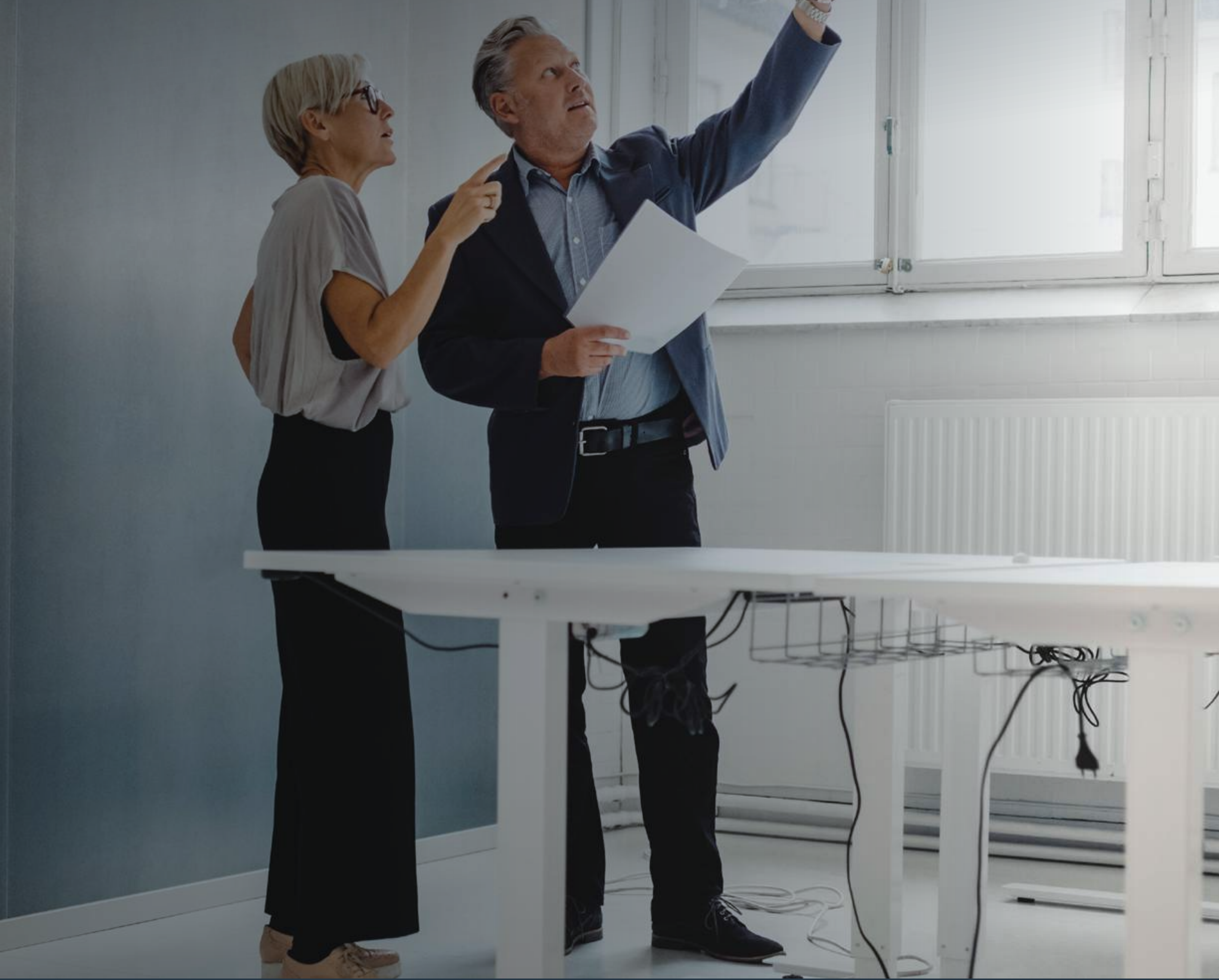
REAL ESTATE INDUSTRY GUIDE

A Property Owner's Guide to Repurposing Real Estate

In a Post-Pandemic World, Repurposing Changes All Things Risk



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2020 will go down as one of the most challenging years ever in real estate. Consider the following:

- The average office occupancy rate in February 2021 was 24.7%.[1]
- A record 159 million square feet of empty retail space has pushed the average retail vacancy rate to 5.7% this year.
- More than 110,000 restaurants — or 17% of the nationwide total — have closed permanently or long term.[2]

As grim as these numbers are, real estate owners and portfolio managers are finding that repurposing properties can ease the pain.

Anchor mall spaces have become warehouses for last mile delivery companies. Restaurants have expanded their property lines to encompass the sidewalk or parking lot. Cannabis retail, extraction and distribution operations are expanding into big box retail buildings, empty store fronts and vacant office suites.

Repurposing helps owners and operators anxious to find uses for empty properties — and business owners get reduced rents and prime locations.

It's also a recipe for increased risk.

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[1]Forbes, "A Cloudy Crystal Ball For Commercial Real Estate And Office Space," February 23, 2021.
[2]Forbes, "U.S. 2021 Retail Vacancy Rate May Rise To 7-Year High After Record Store Closings," January 13, 2021.

4 risk considerations in repurposing real estate

Flexibility is the name of the game in real estate: Current and future tenants want to know if they need to pivot their focus – and if they can do so under the same roof.

However, changing the use of a property changes its risk profile, possibly affecting the asset's property coverage and potentially requiring a new insurance policy or additional coverage limits and extensions.

Here are four considerations you need to account for when repurposing real estate:

1. **Local codes and zoning laws.** Changing a building's zoning designation takes time — and it can be costly to bring a facility up to code or change its specific occupancy type. Both often require additional, unexpected renovations, which means additional costs. Older facilities will require more work and may be harder to rezone. For example, consider what it takes to turn adjoined retail stores into a warehouse: legal fees necessary to petition the municipal zoning board and a renovation to ensure it meets code compliance and can function as a warehouse.

2. **Building ordinance upgrades.** When making renovations or upgrades, building owners may be required to include recent local ordinance changes. In addition, property that suffered damage during a prolonged vacancy may need to build a new sprinkler system, provide wheelchair access or make other improvements to meet local building ordinances that changed during the pandemic. For example, a California municipality passed an ordinance prohibiting buildings higher than four stories — and when a six-story office building suffered fire damage, it was not allowed to rebuild its top two floors. This meant evicting two floors of tenants.

   Building Ordinance coverage, an extension to a property policy, will cover a facility for upgrades required by ordinances passed after the building was constructed. The challenge of Building Ordinance coverage is knowing the right amount to procure. A good rule of thumb is to be covered for an amount equal to 25% of the property's value.

3. **Vacancy clause.** If a tenant has moved and left an asset vacant, the property policy's vacancy clause will either nullify coverage or alter its terms and conditions, effectively reducing coverage. During COVID-19, many carriers didn't enforce the vacancy clause. However, if the vacancy hasn't yet cleared up, obtaining new coverage for a repurposed property will be an issue.

4. **Triple Net Lease.** Owners of large properties, like a big box retail outlet, will often engage a Triple Net Lease. In exchange for reduced rent, a single tenant is responsible for taxes, insurance and utilities. When the tenant vacates the facility, the coverage disappears. Building owners must secure insurance quickly in the event of property damage like vandalism or fire. The Triple Net Lease setup makes it harder to secure coverage (similar to a vacancy clause) when repurposing. Triple Net Lease allows landlords to forced-place insurance on multiple tenants; forced-placed or lender-placed insurance comes into play when an existing tenant fails to pay insurance, so that the building owner avoids both violating the terms of a mortgage and financial penalties for lacking coverage.

Evaluating building systems when repurposing real estate

As a space's purpose changes, its infrastructure and systems must meet new needs. If the owner or tenant of a repurposed building doesn't evaluate these systems, it can lead to trouble. In one example, a plastics manufacturing company moved into a new space assuming that the building's existing sprinkler system was adequate. But after they had moved in, their insurance company determined that the existing system would need to be retrofitted and liquid storage arrangements were inadequate, forcing the company to halt operations until the problems were fixed.

The COVID-19 pandemic has also brought extra considerations for space layout and infrastructure requirements. After more than a year of remote work, it's unlikely offices will look the same again. Organizations will need enhanced telecommunications capabilities to support employees working from home. Workspaces will need to accommodate new social distancing protocols; companies with an open floor layout may want to consider putting up walls.

When repurposing, work with consultants to evaluate each of the building's systems to determine if they can adequately serve the new purpose.

Consider the impact of the following systems:

Fire and life safety systems protect the people and assets working in a property, designed to control fires long enough to allow occupants to exit safely. But a building's fire and life safety systems are more than just sprinklers and fire alarms. It comprises stairwells and emergency evacuation plans including exits and egress as well as understanding the fire hazards of a space and business. All of these elements must be evaluated and updated based on the new purpose of any property.

In light of COVID-19, strong **mechanical systems** are particularly important due to their ability to help with air flow and indoor air quality. Each facility must meet the ventilation requirements of its new business and support the well-being of its occupants. They may need to meet specific mechanical systems codes and standards for their industry to operate.

Different industries put their own demands on **electrical systems**, depending on the amount of power a facility needs for its lighting, cooling and equipment. For instance, manufacturing and healthcare facilities have extensive power needs and require backups in order to maintain critical operations. If the utility provider cannot provide the power needed, site-generated power solutions like generators may be necessary.

Plumbing systems must be considered for their pipe and fittings materials. These materials will determine the life expectancy of the system and timelines for replacement or upgrade. Water can do great damage to a building, and insurers often require frequent inspections of the plumbing systems. Building occupancy is another consideration for the plumbing infrastructure. For example, a restaurant has different plumbing needs than a retail outlet.

Repurpose with a purpose

Because the insurance implications of repurposing real estate are significant, many real estate owners and portfolio managers are reaching out to brokers for an insurance quote when entertaining a deal, long before signing a contract.

Specifically, consider these insurance implications:

Insurance capacity depends on industry. Carriers will not necessarily write a policy for every risk. For example, many underwriters won't offer policies in the cannabis industry, and even when they do, assets with a cannabis tenant carry greater risk than other retail.

The "hard" commercial insurance market. Due to the surge in weather events and building water damage claims, insurance underwriters have become more selective in what they chose to insure — and premiums have risen across the board. No matter how long you've been with a carrier, a repurposed asset may not qualify as a risk they're willing to take.

The reinsurance market. Even a willing underwriter is subject to the risk appetite of their reinsurers. Without reinsurance, underwriters are heavily restricted on the policies they're willing to write.

Repurposing property can help many real estate owners and managers weather the spike in vacancies and unpaid rents due to the pandemic. It's essential to keep an eye on how repurposing changes the risk profile of the property and ultimately affects insurance coverage.

Looking ahead

COVID-19 resulted in the worst year in decades for real estate, and the industry is only slowly coming out of its doldrums. Real estate owners and operators have found that in some cases, repurposing their assets has given them new life for properties they may have feared to have become unmarketable.

Property owners have a mixed outlook for the next 12 months. The hospitality industry is expected to recover throughout 2021, with restaurants and hotels reopening after a horrific 2020. Changes to the transportation industry put demand for warehouses in overdrive and property owners who could repurpose property into warehouses were rewarded. Meanwhile, entertainment venues are awaiting music acts and theater productions to start booking tours.

The changes have meant real estate owners and operators must take a new look at risk management and insurance. Even a relative return to "normal" won't change the need for real estate executives need to reassess their risks and coverage, whether they repurpose their property or not. Talking to a broker is a needed first step to figure out how you can navigate a permanently altered market.

EVICTIONS AHEAD IN 2021

At the onset of the COVID-19 pandemic, building owners gave tenants a three month or longer reprieve from rent, adding that same amount of time to the end of the lease. More than a year later, building owners are ready to recoup their losses and will start enforcing rent agreements.

It's unclear if government entities help keep commercial tenants in their space; each local and state government will provide different levels of funds. Because of the uncertainty, evictions will play a large role in the 2021 real estate market.

Retail, restaurants and mom-and-pop stores are likely to face foreclosures at a higher rate than other tenants. Evictions will affect real estate owners' ability to pay insurance premiums and their ability to maintain existing properties or expand into new ones.

How Key Industries Are Repurposing Property

ENTERTAINMENT
When large crowds are not an option

Entertainment businesses did their best to pivot to streaming events and host parking lot concerts, and in some cases, their sites were used by municipalities for COVID-19 testing and vaccination.

Still many more had no choice but to close up shop. For these, the U.S. Small Business Administration's Shuttered Venue Operators Grant program is designed to provide emergency assistance to cover payroll costs, rent repayment, utility payments, taxes and other fees. However, the program has been plagued by technical and managerial problems, and its rollout was delayed until the end of April.[3]

Other owners purchased less-costly Vacant Premises policies that just cover catastrophic incidents such as fires or floods, with limited general liability coverage.

Many venues are beginning to re-open at smaller capacity, but for too many, anything less than full capacity is not an option. Alternative outdoor events remain a firewall — perhaps temporary — against bankruptcy.

TRUCKING AND WAREHOUSING
Repurposing to meet high e-commerce demand

Ecommerce sales are up 32% since the pandemic,[4] leading to a spike in demand for last mile delivery and more warehousing space near urban centers.

Reevaluate coverage with the following considerations:

- **Warehousing is a business.** It's more complicated than being a retail landlord. As products come in and out, understand the ownership and legal obligation of all parties.
- **Premium rates are tied to safety.** The presence of large amounts of shipping materials increases the risk of fire and will affect the type of coverage required for the space.
- **Warehouse Legal Liability coverage.** This insurance policy covers products against damages caused by a fire, theft or negligence.

[3]Journal of Accountancy, "Shuttered Venue Operators Grant program closes for repairs on its opening day," April 8, 2021.
[4]Digital Commerce 360, "Data Dive: How COVID-19 impacted ecommerce in 2020," March 22, 2021

HOSPITALITY
Finding new ways to use space

Many hotels and restaurants now find themselves slowly reopening at a reduced capacity. Businesses reducing their office footprint will be looking for alternative spaces to accommodate occasional large meetings and conferences. Hotels, conference halls or convention center rooms will fill that need.

While personal travel is already increasing, hospitality underwriters are gearing up for what is expected to be a roaring return to full travel as early as 2022.

CANNABIS
Repurposing for growth

Demand for cannabis extraction, distribution and retail dispensaries has outpaced supply. In states where cannabis was legalized for more than three years prior to the COVID-19 pandemic, demand increases are currently at 42% for warehouse space, 27% for storefronts, and 21% for land to build.[5]

Consider the following when repurposing a space for a cannabis operation:

- **Utilities.** Determine if the space can meet the utility demands of the operation.
- **Zoning codes.** Each municipality will have strict rules as to where cannabis facilities can be located.
- **Increased exposure to theft.** Building owners and other tenants may not appreciate the added risk.
- **Extraction safety.** Extraction services use flammable chemicals for extraction, therefore carriers will require a rigorous inspection and safety audit.

[5] Cannabis Business Executive, "Adaptive Reuse in the Cannabis Industry: The Good, The Bad and The Addendums," March 9, 2020.

CHECKLIST

Choosing the Right Insurance Broker

You want to get advice from people who understand your business and know your industry. Before choosing your insurance broker, be sure to ask these important questions

- [ ] **How long have you been involved in the real estate industry?**
You don't want to be the first. Your business is risky enough.

- [ ] **What percentage of your book are clients like me?**
You want to confirm that your broker spends the majority of his or her time in your industry and understands emerging trends and issues that could impact your business.

- [ ] **How many insurance carriers can you bring to the table?**
Not all brokers have access to specialty insurance companies who serve the real estate/property market. It's important to align with a brokerage firm that is in good standing with carriers and has the best chance of securing optimal coverage and pricing for your business.

- [ ] **In addition to property insurance, what expertise and services do you offer?**
Your broker should introduce you to certified risk managers who know your industry and can help you address safety issues and advise you on technology solutions that are appropriate to your business.

- [ ] **Can you review my contracts and advise me on risk exposures?**
Experienced brokers will review insurance clauses in all contracts and advise you on changes you should make at no additional charge. They should direct you to attorneys who know your business and can review your other business contracts for liability exposures.

- [ ] **What experience does your team have when it comes to claims?**
When you file a claim, both your broker and your account management team should be committed to advocating on your behalf with the insurance carrier.

- [ ] **What other services or expertise can the broker offer?**
Ask if your broker can introduce you to their counterparts in employee benefits consulting. There are so many new ways to support the needs of today's workforce and you need a specialist to advise you on benefits.

As a real estate owner, developer or operator, you'll need an insurance broker who is structured to handle your needs in a seamless manner and avoid gaps in coverage. Working with a single brokerage firm with knowledge and experience on both sides of the border reduces your risk and your administrative workload.

Strategic support that puts you in control

When you partner with us, you're at the center of a vast network of experts who will help you reach your goals. With HUB, you have peace of mind that what matters most to you will be protected — through unrelenting advocacy and tailored solutions that put you in control.

For more information on how to manage your insurance costs, reduce your risk and take care of your residents and employees, contact a HUB real estate insurance specialist.

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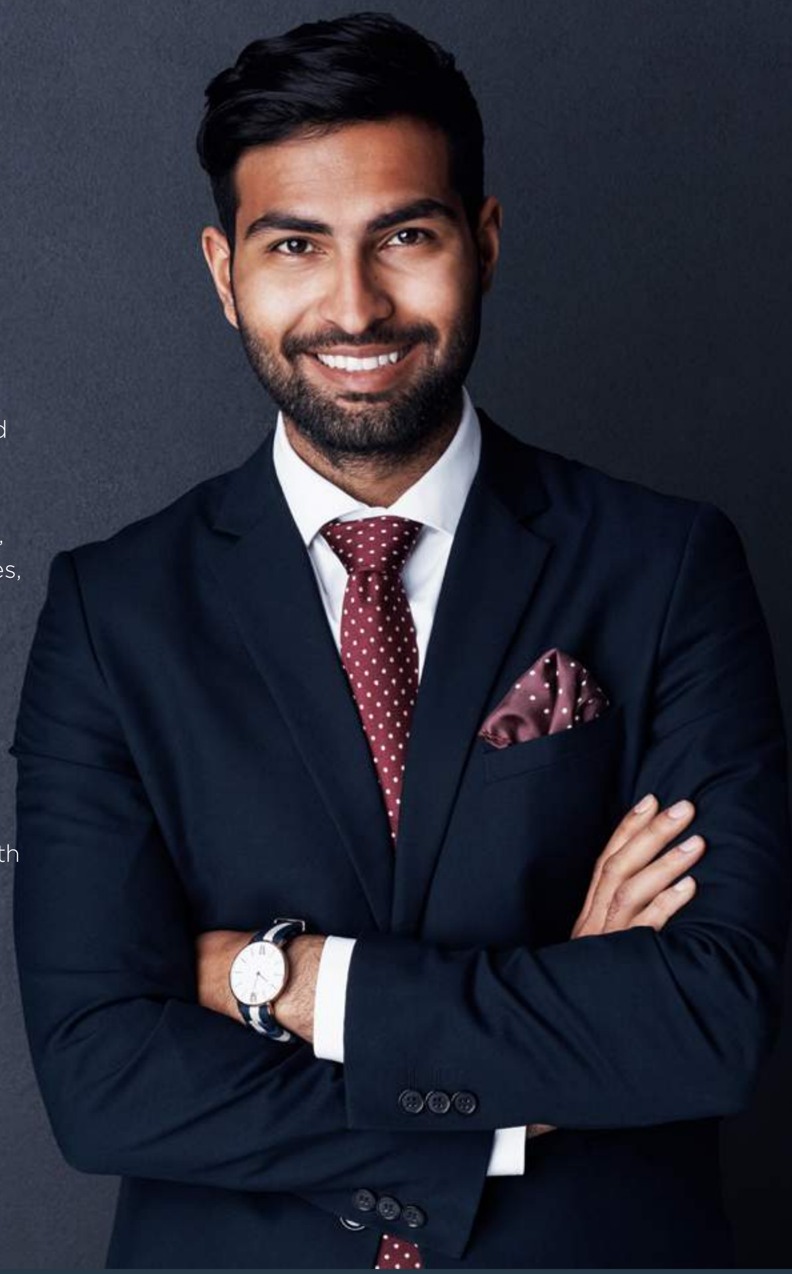

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