
MANAGING YOUR COLIVING PROPERTY POST COVID-19... A LEGAL PERSPECTIVE

We spoke with Jonathan Mills and Andrew McCormack of [Osborne Clark](#), an international legal practice that works with coliving developers and operators in Northern America and Western Europe. They share what the legal basis of the relationship between coliving operators and property owners can look like, and how Covid-19 is changing the landscape.

The COVID-19 pandemic has really shone a light on how coliving operators manage their real estate assets. Many coliving operators that have struggled recently have pointed a finger at a master leasing structure that leaves operators exposed when occupancy rates unexpectedly drop. But what, if anything, is the alternative?

MASTER LEASE

The term 'Master Lease' has slightly different meanings depending on the jurisdiction and the asset class. In this article we will be considering Master Leases conceptually, on a broader neutral basis. When referring to Master Leases we are talking about agreements relating to real estate assets that are generating some kind of income, for instance retail stores or coliving assets. Under a Master Lease, the lessee (the tenant – a coliving operator for the purpose of this article) will take the benefit of all profits from income generation and tax benefits. The tenant will be responsible for utility charges, maintenance and repair and general management of the asset. The lessor (landlord) will receive rental payments from the tenant, typically by way of periodic instalments.

WHAT IS THE ALTERNATIVE TO A MASTER LEASE?

Under a Property Management Agreement (PMA) a property owner will appoint a manager to provide certain services in respect of the property. In a coliving PMA these typically include filling the building, repair and maintenance, marketing and advertising and

rent collection. In exchange for these services, the property manager will be entitled to payment of a management fee equating to an agreed percentage of the gross rental income over a predetermined period. Depending on the property manager's bargaining position other benefits can be negotiated i.e. bonus payments for high performance of the asset.

The property manager will generally be entitled to reimbursement of the costs and expenses incurred in providing the services. Rent belongs to the property owner and the property manager will not be deemed to have 'exclusive possession' of the property (and the associated rights) but rather operates the asset by way of licence.

WHY PROPERTY MANAGEMENT AGREEMENTS ARE CONSIDERED PREFERABLE IN A COLIVING CONTEXT

The COVID-19 pandemic has shown the benefit of operators being 'asset light', not having fixed periodic rental payments putting a strain on the balance sheet and cash flow of the business. Some operators have found dropping occupancy rates and less rental income to conflict with their master lease business model (and also potentially short term revenues). Regardless of the economic climate, master leases require the payment of pre-agreed rent.

PMAs are often drafted with a greater degree of commerciality and can be tailored to the management of a coliving space. A traditional master lease, which does not envisage the management of such a unique



asset, is often not the best medium to clearly set out responsibilities and incentives for the contracting parties.

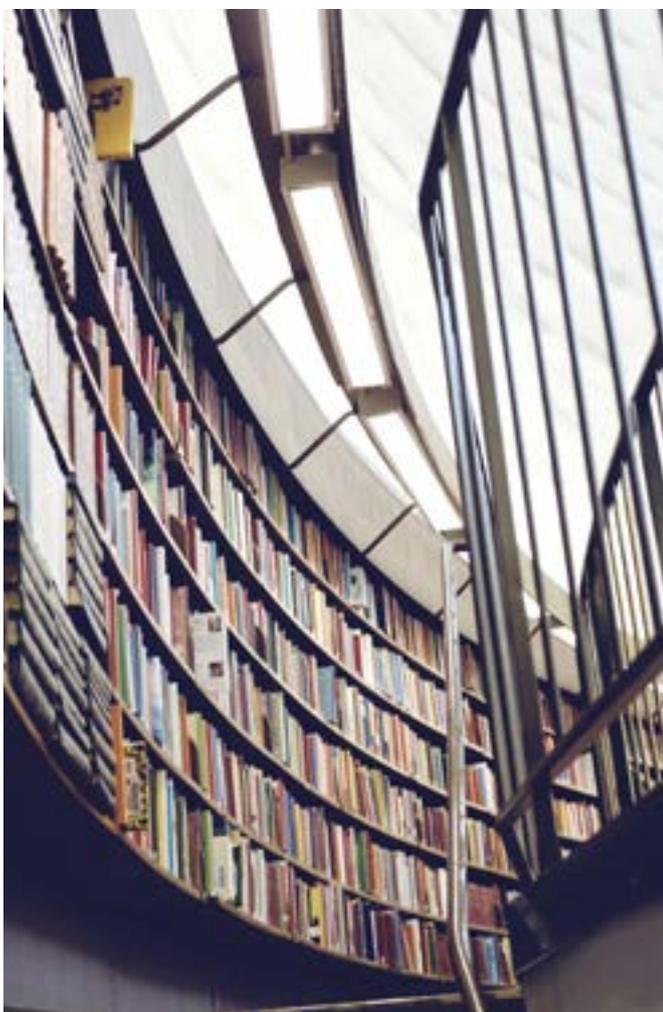
A PMA should not be seen as a 'bad' or undesirable document for a property owner. The remuneration structure incentivises best in class management by an operator, leading to potentially higher returns for the property owner. Also, an operator will not have the benefit of prescribed termination protections afforded by local law - the operator does not have an interest in the land, which it would have under a lease - but a contractual agreement with the property owner thus giving the property owner additional flexibility in managing its asset.

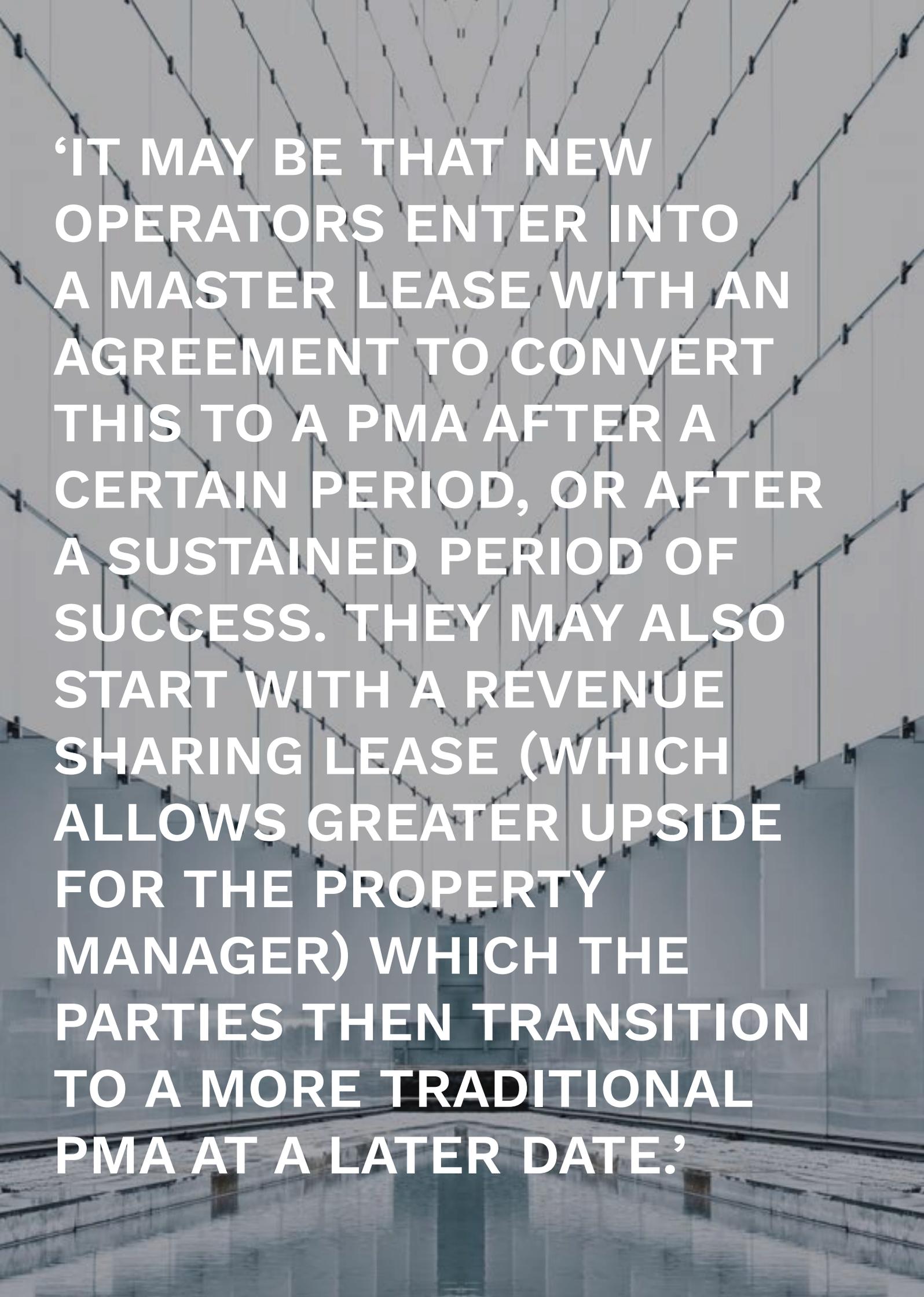
In addition, many (not all) funders will not finance a Master Lease structure at the same rate as they will a management agreement. The property manager can be viewed as a single credit tenant on the property as opposed to having multiple individual credit tenants in a multi-let property. The risk factor when considering the credit of a single tenant will always be much higher than it will be when it is spread across many tenants.

OTHER CONSIDERATIONS – WHY MIGHT EACH PARTY ACTUALLY WANT A MASTER LEASE?

A Master Lease would be the traditional route for a property owner. The fixed income (not based on the revenue generated by the property manager) provides certainty and is institutionally welcomed. For property owners Master Leases are the devil they know and understand. They have used them for years and, like many in the real estate industry, are resistant to change.

For a property manager, a Master Lease provides the opportunity to keep the rewards for exceptional performance of the asset. A property manager keeps all returns over and above the rental payment. In addition, depending on the jurisdiction, the property manager may be afforded greater protections under local real estate laws. This often comes in the form of protection from eviction. A coliving operator would not want to be removed from its property management role on short notice under a PMA having already invested time and effort into the asset. Termination rights and timings under a PMA are, of course, negotiable.





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WHAT CAN OPERATORS DO TO TIP THE BALANCE IN FAVOUR OF PROPERTY MANAGEMENT AGREEMENTS?

Ultimately, the basis of the management (Master Lease or PMA) will be at the discretion of the property owner. Clearly a PMA will continue to be the choice of operators, but how can they best convince property owners that a PMA is the best option for all involved?

Following the demise of WeWork and its Master Lease model, the COVID-19 pandemic has shown an unexpected resilience to the multifamily and coliving markets. Coliving is no longer a new concept. There is a clear change in the way that younger generations want to live. The market now has several years of data showing how coliving can notably increase the net operating income of an asset. A PMA gives the property owner the opportunity to receive higher income than under a Master Lease, with a manager incentivised to provide best in class service in order to maximise its own returns, allowing a property owner to benefit from this increased NOI.

Despite all the positive aspects of a PMA, a property owner will still likely look to a manager's track record and brand to determine whether to collaborate with a manager on a PMA structure. Established operators are therefore likely to have a greater bargaining position when agreeing on how to structure their relationships with property owners. It may be that new

operators enter into a Master Lease with an agreement to convert this to a PMA after a certain period, or after a sustained period of success. They may also start with a revenue sharing lease (which allows greater upside for the property manager) which the parties then transition to a more traditional PMA at a later date.

If there is anything the COVID-19 pandemic has shown us, it is that managers should resist absorbing the real estate risk for their property owners under Master Leases. Coliving operators are reporting strong rent-collections and a strong pipeline of future community members. Post-pandemic, property owners will be looking for stability and to maximise the value from their assets. Coliving property managers would seem well placed to answer the call.



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Andrew is a Senior Associate in the Osborne Clarke real estate team and based in the London office. Andrew is focussed on 'Living' assets and has particular experience on matters involving investment, development and operation of purpose-built student accommodation. He focuses on the internationalisation of Osborne Clarke's market leading student accommodation practice, and works with Jonathan in assisting Osborne Clarke's coliving clients.