IS IT TIME FOR LANDLORDS AND TENANTS TO WORK TOGETHER?

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Waypoint

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The structural change already impacting the retail sector has been exacerbated by the COVID-19 pandemic, accelerating the consumer shift to online buying and impacting heavily on the turnover and profitability of most forms of retail. Grocery and local convenience retail have been the exceptions.

Given future trading uncertainty, a range of tenants are known to have contacted landlords with a view to negotiating alternative and, what the tenant might consider to be, more equitable lease terms. The legacy of COVID-19 will almost certainly be a permanent change to the structuring of new retail lease agreements.

In this short briefing note we consider the Turnover Leasing Model and highlight some of the issues that both landlords and tenants need to fully consider.

TYPES OF TURNOVER LEASES

There are various permutations of the turnover lease, but typically the following three forms are the most commonly applied in the UK market:

1 THE FUTURE — Pure turnover rent: Rent = agreed % of sales

- Two options: inclusive or exclusive of base costs (business rates and service charge).
  - A higher percentage of sales will be applied if the lease agreement includes total occupancy costs.
  - Alternatively, if the retailer is responsible for the base costs, then the turnover percentage applied will be lower.
- WAM's preferred option would be a turnover rent exclusive of base costs, particularly in the current market where business rates concessions are available to retailers. This would hopefully guarantee that the running costs of any shopping centre are covered.
- A variance to this approach would be to calculate the turnover rent element based on percentage of turnover per sq. ft.

2 THE PAST — Fixed base rent (agreed % of OMV) plus turnover top up

- This approach has been used in a number of UK shopping centres, typically applying a base rent of 80% of the open market value.
- The percentage of turnover agreed can be fixed or set to increase in steps as turnover thresholds are met.
- At review, the agreed base rent can be linked to an index or to upward only review to OMV.
- In our view, retailers will be averse to this model going forward as it is still heavily reliant upon agreeing an open market rent which, in the current climate, is extremely challenging.
- This type of lease still favours the landlord, with the turnover top-up being a relatively small amount.
- For acceptance of this lease option going forwards, retailers will be seeking a much lower base rent.

3 THE MIDDLE GROUND — Fluctuating base rent

- The tenant pays a fixed percentage of turnover as rent, but the base rent is re-set each year by discounting to 80% of the previous year's turnover rent.
- At the end of each year a reconciliation is completed and if the turnover percentage exceeds the base rent then the landlord receives a top-up rent, but if the turnover rent is less than the base rent then the tenant receives a credit.
- This model aligns the interest of the landlord and tenant whilst providing a simple mechanism for monthly or quarterly on-account payments without the need for regular auditing and certification.
- Subject to achieving further transparency on what constitutes turnover rent, we believe this model will provide for much stronger collaboration between landlord and tenant and be well suited to the challenging conditions anticipated in the short- to medium-term.

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DEFINING TURNOVER

Defining turnover has become ever more complex as retailers have embraced multi-channel retailing. From a landlord's perspective, turnover should encompass as broad a definition as possible, capturing all income relating to the premises in facilitating a transaction.
This might include some or all of the following:

- Cash through tills
- Online orders placed in store or remotely and collected in store, delivered to home/office and including fulfilment from stock at the premises
- Sales made on credit or instalment plans - the full cash price at point of transaction
- Sale of gift cards or vouchers
- Rent or income from in-store concessions and franchisees
- For F&B tenants, include take-away orders (phone, website and third-party apps, such as, Deliveroo and Uber Eats).
  It may be possible to apply a higher turnover percentage to take-away turnover due to the higher margin being achieved

In calculating the turnover, no deduction will be made for:

- Bad or doubtful debts
- Discounts allowed to employees of the tenant - full cash price must be included
- Discounts or commissions payable by the tenant to the provider of credit in the case of credit card transactions

The following elements will not be included in the turnover or, if included, will be deducted:

- Online orders with no transactional connection to the physical store, i.e. where no stock selection or collection is captured in the value chain
- If this were to be included it risks double counting, with different landlords each claiming the sale revenue
- Turnover for returns of goods bought in-store
- Turnover for returns of click-and-collect orders fulfilled from the store
- Food and Beverage customer tips
- VAT

TURNOVER PERCENTAGES

Different types of retailer trade at different trading densities, with a wide range of sales per sq. ft. / per m² ratios being achieved. In the current market, it is clear that historically established turnover percentage benchmarks may no longer be appropriate. The situation is evolving and we expect this to be an area for negotiation going forwards. In addition, the turnover rent model may not be suited to all.

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THE WIDER IMPACT OF A MOVE TO TURNOVER RENTS

The impact of a transition to turnover rents is complex, but there are three key areas to consider:

1 Investment values

- In the short- to medium-term the move to turnover rents will create huge uncertainty in NOI, particularly for shopping centres.
- Even pre-COVID-19, the retail market in most locations in the UK was suffering a structural mismatch between supply and demand.
- The situation has simply been exacerbated since March 2020.
- There is a lack of "rental tension" and the majority of locations could be described as being a tenant's market.
- In an oversupplied market, lacking transactional evidence, it is difficult for parties to agree a fair rent.
- Given the lack of certainty in income, it does raise the question "on what basis do valuers approach shopping centres?"

2 Concerns for lenders

- For many shopping centres there is a concern that declining occupancy levels and rents may barely cover running costs. In the short- to medium-term, a shift to turnover rents will only exacerbate this uncertainty leading to material concerns over loan to value covenants and interest payment obligations.
- A stagnant transaction market, with limited exit routes, means lenders will need to work with borrowers or best in class asset managers to carefully control costs and maximise net operating income during what will be a major transition in the retail economy.
- As landlords and tenants move towards a collaborative approach, we anticipate greater flexibility in leases which will inevitably continue to get shorter although, in return, occupiers will need to forego their historical rights to security of tenure.
- Given time, a switch to flexible turnover leasing arrangements may see shopping centres which can provide a track record of net positive cashflow valued at a multiple of income, with values ultimately underpinned by any residual redevelopment or alternative use value. Lending may also shift from the current asset backed valuation model to one more akin to operational business lending.

3 Asset management

- The market needs a new sustainable leasing model based on trust and collaboration between landlords and tenants.
- This will require high frequency, high quality data capture relating to all forms of turnover benefiting a retail unit.
- In addition to the change in the rental basis, the approach to rent free periods and capital contributions requires a thorough review.
- Retailers' expectations need to be managed.
- The "glitz and glamour" days are gone.
- A functional, low cost unit and fit-out is more appropriate in today's retail climate.
- A more cost effective, shared risk model needs to be adopted where both landlord and retailer capital expenditure, whilst proportionate, is minimised.
- Further, a landlord's break option could be included in the lease should turnover fall below an agreed threshold. This would allow a more pro-active approach to removing underperforming tenants and bringing in new concepts on flexible terms.

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TRANSPARENCY IS THE KEY

In an already challenging retail market, COVID-19 has prompted renewed dialogue between landlords and tenants. Is this the time for improved collaboration to find a rental model that is deemed to be more equitable and generates a win-win for both landlords and tenants?

The release of confidential turnover data is a primary issue. To ensure trust and a positive relationship the landlord must be confident in receiving comprehensive, accurate and timely turnover data. In return, the tenant must be confident that sales figures remain confidential between the two parties.

The solution, at least in terms of physical store sales, is for the landlord to have a link to the in-store EFTPOS (Electronic Funds Transfer at Point of Sales) system. This access to sales data is written into the lease agreement and is a common solution amongst shopping centre and outlet centre landlords. However, not all retailers use the same EFTPOS system. An issue, but surely not insurmountable. Perhaps it is time for industry bodies like Revo and the British Retail Consortium (BRC) to facilitate and encourage collaboration and a move towards a transparent system that benefits all parties.

Improved trading transparency will help the landlord with asset management initiatives, giving early warning of struggling retailers where some flexibility might be warranted, but also identifying strong performers where moving rents on at review should prove less of a challenge.

Other issues include accounting for non-store sales. Maybe, based on historic turnover data, an agreement is reached on the proportion of total sales that is represented by non-store sales (online, click and collect etc.). This figure should be reviewed annually.

International retailers' online business is usually kept separate from their physical store business for tax reasons. The same principal as above could be applied, using historic online sales data.

Ensuring accuracy and trust in the data being received will incur additional administration. It may be that smaller independent retailers, with low turnover, are not required to have their accounts audited. For more established retailers there will be a need for quarterly management accounts to be signed off and an annual audit. While this additional administration may come at a small cost, it is just one part of building a stronger landlord / tenant relationship that should ultimately benefit both parties.

CONCLUSION

- Arguably, the transition away from traditional leases to some form of turnover model has been building for some time. COVID-19 is acting as a further catalyst for change. It will, of course, take some considerable time for the whole market to change.
- In what was already a challenging UK retail market, undergoing major structural change, the pandemic has further highlighted the fragility of some retailer operating models.
- There is a real danger that without a more flexible lease structure, without more sharing of the risk and reward and stronger collaboration between landlords and tenants, some shopping centres (and retail parks) will decline to a point where the rental income, from standard leases or turnover leases, will not cover the base costs of running the centre.
- The current stress fractures seen in the retail market will lead to a different approach to leasing, with some form of sustainable turnover model likely to be the preferred option. For weaker centres, a move to the outlet centre model, with leases outside the L&T Act, minimal fit out costs and turnover only leases will allow greater flexibility to manage the centre pro-actively. With the right tenant mix, let on short leases and pop-ups, regular new entrants will create vibrancy, higher footfall, higher turnover and higher rental income.
- Due to a lack of short-term exit opportunities, lenders will need to work closely with borrowers or best in class asset managers to ensure the longer-term viability of shopping centres during this period of major transition.