

# **ADAPTATION OF THE RETAIL INVESTMENT MARKET IN THE UK: changing tenant covenant perceptions and flexibility in the lease model**

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## **ABSTRACT**

The retailing industry in the UK, while dynamic and responsive to changes in consumer demand, is experiencing unprecedented structural change. The focus of attention on the consequences of these changes for urban centres has typically been on the retailers themselves and the impacts on local services and economies but with little attention given to the implications for property owners. Yet, understanding the responsiveness of landlords and their behaviours is an important step towards mastering and managing the adaptive mechanisms within a retailing system.

A qualitative research approach is adopted in this study to examine the changes, before and during the pandemic, on the retail investment market. The findings, based on the analysis of primary data collected in semi-structured interviews, reveal fundamental changes in the leasing model. This paper explores the changes to the lease model and landlords' perceptions around tenant covenant, and the implications for the valuation of retail assets.

**Keywords:** Retail market, lease model, turnover rents, tenant covenant

## **INTRODUCTION**

The retailing industry in the UK is experiencing unparalleled structural change, driven by intensifying online shopping and spiralling operational costs (CBRE, 2018; Dolega and Lord, 2020; Jones and Livingstone, 2018; Wrigley and Lambiri, 2015). The focus of attention has typically been on the disruption the reorganisation of the retailing industry has caused on the High Street (Guy, 2010; Grimsey, 2018). While store closures and the collapse of retailers are well documented (Cobb, 2019, Centre for Retail Research, 2021), our understanding is limited regarding the effects of the restructuring on the retail property market in the UK.

This study, as part of a wider project looking at the adaptive capacity of urban retailing centres, is interested in how these changes, before and during the pandemic, may be impacting on how property is used, owned and managed, and how investors are responding. Hence, the researchers seek, through the collection and analysis of primary data, to investigate the adaptations being made in the ownership and management of property assets and how established real estate market practices are adjusting in response to the changing requirements of tenants. In doing so, the adopted qualitative approach adds new insights into the flexibility of the retail leasing market, and impact on retail's investment characteristics and investment market.

The operation of the retail market, rooted in complex system theory, is set out in the next section before the focus narrows to develop a framework that encapsulates the risk and return attributes of retail investments. The sampling, interviewing and coding methods employed are explained in Section 3 with the emerging subthemes analysed in section 4. Here, the discussion reveals changes to tenant covenant perceptions, the retail leasing model, and the valuation process. Reflections on these findings are given in Section 5 along with some conclusions.

## **ADAPTATION IN THE RETAIL PROPERTY: A THEORETICAL FRAMEWORK**

Growing consensus is that retail markets are urban systems with adaptive resilience (Dolega and Celińska-Janowicz, 2015). In such a system, anticipating, evolving and adapting to exogenous shocks is driven by actors

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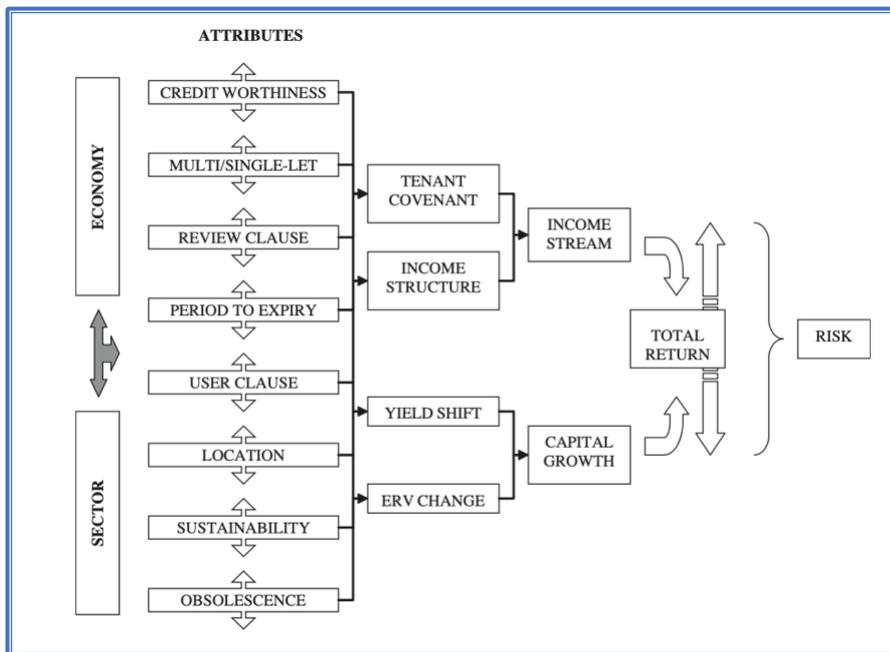
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and their social agency. The more varied the actors, the more varied their responses (Capello, Caragliuy and Fratesi, 2015), which are shaped by other attributes endogenous to the system, including the size, diversity and organisation of the functions within the urban centre, and density and nature of the social relations that interconnect actors and organisations to the wider economy. This complex array of factors interacts to determine the capacity of the retailing centre to react, whether anticipated or not, to shocks to produce new organisations, interdependences and further heterogeneity (Wrigley and Dolega, 2011).

The urban retailing system encapsulates perhaps the most diverse range of stakeholders and influences of any property sector whose interests and aspirations are multiple and complex. One key stakeholder, the property owner, is instrumental in tailoring the built environment to meet the needs of retailers, shoppers, and society more widely. As retailers in the UK have re-organised in response to market shocks, their use of space has changed, and shops in some locations and some retailing forms have become obsolete (Savills, 2020). Here, the market needs flexible and responsive landowners to prevent long term vacancies and blight by reusing and repurposing this redundant space. Subsequently, land use change and urban renewal are important features in the adaptive cycle of an urban centre (Dolega and Celińska-Janowicz, 2015).

Landowners and investors (encapsulating developers) are the element of the retailing system responsible for developing, adapting and managing properties. Although a heterogeneous group, ultimately their business decisions are driven by two factors - their expected return and the risks attached to that expectation. Ultimately these factors are important considerations regardless of the investor being in the private- or public-sector although, while larger-scale private sector investors usually have responsibilities to shareholders, public sector investment must of course be value for money and (similarly) publicly accountable. Investment viability is the ultimate driver of private-sector investment, and if landowners and investors are to facilitate adaptation in the retail sector they too need to adjust their perceptions of investment risks and return expectations (Wiejak-Roy *et al.*, 2019).

**Figure 1. Real estate attributes, return and risk**



Source: Jackson and Orr (2011)

Retail property investment returns consist of two components - rental income and capital growth – both fundamentally linked to demand and supply conditions within the local market an asset is located. Changes in the scale, nature and location of property sought by users, and the price and occupational terms they are willing to agree to have implications for the investment quality of an asset.

While rental income has traditionally been determined by market rent at the time of negotiation, capital growth is driven by movements in asset prices which reflect relative changes in the estimated rental value (ERV) and

the capitalisation rate (referred to as yield in Figure 1). Movements in the capitalisation rate depends on, amongst other things, changes in the risk premium reflecting the risks perceived to be attached to the investment (Crosby *et al.*, 2016).

The strength of the covenant of an occupier and their financial standing, underpinned by conditions in the retailing sector and wider economy, determine the security of a rental income stream and the likelihood of a tenant defaulting on their lease obligations, which can to some extent be diversified by letting space in a property to multiple tenants (Blundell *et al.*, 2005; Investment Property Databank, 2000; Adair and Hutchison, 2005). An increase in the financial fragility of occupiers negatively impacts on investors' perceptions of covenant strength, leading to upward shifts in investment yields.

Physical attributes of a property, such as its condition, layout, functionality and degree of flexibility to accommodate different potential users, its location and period to lease expiry can make a vacant property difficult to relet, thereby determining the asset's void risk. Tactical management of these attributes, where possible, and the terms of the lease when the property is relet, shapes the structure and stability of the rental income by dictating the frequency and timing of the income flows (Baum *et al.*, 2021). Leases that were for 25 years with 5 yearly rent reviews were commonplace in the 80s but lengths have steadily shortened. Greater flexibility in the leasing model enables the market to handle further shifts in tenant requirements but data to support a view of what has been achieved more recently in the market is incomplete as is our understanding of how the social relations between landlords and tenants, which are intrinsically linked to the leasing negotiation process, have adapted.

The causes of specific risks outlined above not only drive movements in expected property yields, but also the income growth potential of individual assets and the ease by which an investor can release locked-in capital by resale of their asset (Jackson and Orr, 2011). General consensus is that the specific risks attached to retail investment have risen, and institutional funds and other risk adverse investors have responded, a process Jones (2010) identifies as starting in the early 00s, by disposing of their assets. The trend in disinvestment is also revealed by Orr *et al.* (2021). Yet, opportunistic investors appear to be drawn to these higher risks at a time when contracting rental incomes and tumbling asset prices imply the higher returns to adequately compensate investors are unachievable so there is scope to improve our understanding of investment behaviour in turbulent market conditions. More also needs to be understood with regards to possible changes in market pricing (Jones *et al.*, 2017) or how valuation and property management practice are possibly innovating to help the investment market adapt to the uncertainty and alterations in the user market.

To recap, a series of broad themes are identifiable from the above framework that require further investigation to understand the adaptation being made in the retail investment market in response to ongoing structural transformations within the retailing industry. Changes may be occurring in the expectations and practices of landowners, and include the following areas for further enquiry:

- I. challenging covenant strength perceptions;
- II. flexibility in the lease model;
- III. changes to pricing and valuation/appraisal practice;
- IV. investment risk perceptions of retail and the behaviour of owners;
- V. rebalancing of the landlord and tenant relationship;
- VI. spatial adjustment in the locational quality of assets; and
- VII. tactical property management.

All these adaptations have potential to directly impact on retail's investment characteristics and performance. The focus here, however, is on covenant strength perceptions and the leasing model.

## **RESEARCH METHODS**

A qualitative research approach underpins this study, in pursuit of the aim to provide an in-depth exploration of the experiences and views of landlords and property professionals with regards to the management of retail assets and how their practices are changing. Semi-structured interviews are used to collect the phenomenological data necessary for this study.

## Survey sampling and procedures

Purposive sampling, following the single stage sampling principles established by Kemper, Stringfield and Teddlie (2003), is used to recruit retail landlords and property professionals as interview participants that operate within at least one of the five case study markets under investigation: Edinburgh, Glasgow, Hull, Liverpool and Nottingham. Target participants are identified and selected from a list of landlords and surveyors from property company and consultancy websites, CoStar's and Completely Retail's property marketing databases and professional networks accessible to the researchers via linkedin and IPF. All individuals identified are experienced professionals who are able to communicate their experiences and opinions in an articulate, expressive, and reflective manner.

In all, 66 potential applicants<sup>3</sup> are invited by email, with follow-up telephone calls for non-responders. 27 individuals, spanning five centres, agree to be interviewed which takes place in one of two tranches. The first tranche of 13 interviews are conducted in January to March 2020 (Pre-C19), just prior to the Covid-19 restrictions being imposed. These interviews involve participants active in Glasgow, Edinburgh, Hull and Liverpool with ten conducted face-to-face and three by telephone as recommendations against travel start to be imposed. The interviews are then suspended as the UK property market ground to a halt in lockdown. The second tranche of interviews take place January to March 2021 (Post-C19) after market activity has been re-established with a further fourteen interviews undertaken by telephone or by Zoom or Teams at the request of the participants.

The sample criterion is constructed to cover the variation that may exist in the experiences of retail property specialists (and to address the potential limitations highlighted by Palinkas *et al.* (2015) when using purposive sampling), with respondents working for a mix of local, regional and national property consultancies and investors. Some participants specialise in the management of a single shopping centre, others manage a range of assets; some deal solely with retail while others deal with retail as part of mixed developments; and some property practitioners have experience working for or on behalf of occupiers as well as landowners.

**Table 1. Sample**

Pre Covid 19 (Pre-C19)		Post Covid 19 (Post-C19)	
AMgt01; Edinburgh	PPS02; Glasgow	<u>AMgt03; Nottingham</u>	<u>PPS09; Nottingham</u>
AMgt02; Glasgow	PPS03; Glasgow	<u>AMgt04; Liverpool</u>	<u>PPS10; Edinburgh</u>
PMgt01; Glasgow	PPS04; Glasgow	<u>AMgt05; Hull</u>	<u>PPS11; Liverpool</u>
PMgt02; Glasgow	PPS05; Edinburgh	<u>AMgt06; Edinburgh</u>	<u>PPS12; Hull</u>
PMgt04; Hull	PPS06; Hull	<u>PMgt03; Liverpool</u>	<u>PPS13; Nottingham</u>
PortMgt01; Edinburgh	PPS07; Liverpool	<u>PMgt05; Hull</u>	<u>PPS14; Liverpool</u>
PPS01; Edinburgh		<u>PPS08; Nottingham</u>	<u>PPS15; Nottingham</u>

The interviews are undertaken and the sample expanded until no new insights are revealed, thereby indicating saturation has been reached. A total of 27 participants<sup>4</sup> take part in the interviews: one manages a portfolio fund with past and present retail asset holdings across the case study centres (PortMgt); 6 are asset managers managing retail assets on behalf of private and/or public-sector owners (AMgt); 5 are property managers, managing in-town retail units and/or shopping malls (PM) and 15 are involved in property agency, valuation and transaction services (PPS) advising landlords and occupiers. See Table 1 for the detailed breakdown.

<sup>3</sup> The sample of potential interviewees consists of 12 females and 54 males which reflects the male dominance in the UK property industrial. Of the 66 contacted, 27 agree to be interviewed while 10 of those contacted no longer deal with retail asset management or agency in the case study markets. The remaining 29 either do not respond to the communication attempts or are unable to take part in the study at the point of contact.

<sup>4</sup> While no incentive is given to encourage participation and the sample covers a broad range of professional perspectives, self-selection bias cannot be completely ruled out as the professionals who are willing to be interviewed tend to be those with genuine interest in retailing and the future of the high street.

## Interview format

Semi-structured interviews are used to explore a series of broad themes. Thus, a series of questions are put to each participant, inquiring into each key theme in turn, enabling detailed exploration of the changes occurring in the case study retailing market within which they operate. The same semi-structured topic guide is used to structure the questions asked of the asset managers, portfolio manager and property managers while a slightly modified version which addressed issues specific to property agents is used for the practitioners dealing in agency, valuation and transaction services. This enables the analysis to draw out similarities and differences between agents and landowning representatives working in different locations.

## Coding procedure

The interviews, all bar one, are audio-recorded with permission of the participant, transcribed verbatim, anonymised, coded and then interrogated using abductive thematic analysis. The coding is undertaken independently by two researchers who later compare results, the purpose being to enhance the reliability of the data as it enables the interpretation of the meaning of what is said to be verified (Cope and Kurtz 2016). The broad themes that emerge from the literature are initially used to deductively code the data, facilitating the identification of 28 sub-themes that inductively emerge from the data. These broad themes and sub-themes are represented by the hierarchical coding tree shown in Figure 2<sup>5</sup> (See Appendix). The analysis of the coded data then carefully navigates across the multiple participants to ensure comparisons between interviewees, and within and between the five case studies can be managed.

## ANALYSIS

As can be seen in Figure 2, seven broad themes are used to frame the inductive stage of the analysis. The discussion that follows focuses only on the first two broad themes starting with the changes to covenant strength perception and the leasing mode, before examining the changes in valuation practice.

### Challenging covenant strength perceptions

Covenant strength represents the risk of a tenant defaulting on their rental payments. For many landlords the credit worthiness of tenants is an important consideration as the higher the default risk attached to an asset then the higher the capitalisation rate used to value the property and lower the asset's value.

Two sub-themes emerge around perceptions in the market to covenant strength and subsequently default risk.

### Shake up of established covenant assumptions

The traditional requirements of investors are strong covenants and that preference persists for most institutional landlords. Strong covenants, traditionally linked to blue chip companies and big brand retailers, underpin investment yields and the value of assets (AMgt01, PMgt05), and often investors would reject potential tenants with covenants perceived to be relatively weak. Local and regional owners under this traditional ownership model are more likely to take a wider view on the financial standing of an occupier but if given an option would also prefer the stronger covenant (AMgt05).

Big brand retailers with strong covenants were generally expected to be national and international multiple retailers – for example, Zara, Next, Arcadia, Debenhams, Marks & Spencer - but the number struggling has grown since 2017 and no longer perceived as financially strong (5A1 in the Dun & Bradstreet ratings) (AMgt06). Some large retailers have gone into administration, others have used CVAs, often with landlords being left holding vacant and large redundant spaces. The speed of collapse of established companies and level of economic uncertainty has left investors and agents (for example, PPS15) questioning their previous assumptions about which retailers have strong covenants and how secure rental income streams are:

*“From a property investor point of view [...] Nothing's safe anymore.”* (PPS01, Edinburgh, Pre-C19)

Investors prefer, and in the past had the power to command, that parent companies guarantee rental payments but, increasingly, deals are being agreed with weaker sub-companies or tenants are sold to owners with a

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<sup>5</sup> Figure 2 presents the full coding framework for the sake of transparency. Its development and full findings on the other broad themes can be found at Orr *et al.* (2021).

different debt structure (PMgt01). Investor uncertainty is not helped by the credit assessment score provided by Dun & Bradstreet or Experian being based on credit histories that are backwards looking and can be up to a year old (PPS10). Hutchison *et al.* (2008) argue that more robust risk evaluations, particularly in a falling market, should be a greater consideration for investors and valuers.

The upshot of conditions in the market is that ***“the kind of stable of retailers, as a landlord that you want, has become smaller, and smaller”*** (PPS03), demand is low from tenants with strong covenants, particularly in Hull (PPS12) and strong covenants are not what they were previously and can change suddenly. PPS09 concludes that this ***“gets us to the stage now, where you think what is covenant? Does it really matter who you put in as tenant because they will just CVA or admit?”***

Examples of retailers who have collapsed include Arcadia (PMgt05); Patisserie Valerie (PMgt01) and Debenhams (PPS15) while PPS03 highlights the surprising poor Experian rates associated with fashion retailers such as H&M and New Look. These problems have only been magnified by the pandemic with many investors waiting for the dust to settle to see which retailers survive (AMgt04, PPS15).

Value and discount retailers – such as B&M, Poundstretcher and Home Bargains – historically have not been perceived as having strong covenants and would not be found on the prime pitch in city centres. This is changing with an example of Poundland appearing on Princes Street, the traditional prime pitch in Edinburgh (AMgt01, PPS05). These retailers are financially strong, growing and have good records of paying their rent (PPS03, PPS05). ‘Good tenants’ although there is still the tendency for some professionals to see their presence as indicative of the prime pitch weakening, inferring that some investors need to look beyond out-dated perceptions and biases.

### **Strengthen position of independent retailers**

Independents were traditionally seen as weaker covenants and less desirable tenants but that perception seems to be changing for open minded landlords (PPS12, PPS14). This, in part, reflects the uncertainty associated with chain tenants; also partly due to the realisation that these tenants, if business minded, are committed to a location and making their business work (PMgt05, PPS11). However, they are still seen as a risk that can effect investment yields although vetting can help manage the additional risk (AMgt05). PPS14 makes the insightful observations that there is ***“no point in having a so-called big covenant or strong covenant because, you know, these, these companies go into administration or CVA. So I think there’s a lot more open-minded landlords about independents and things like that now, and I do think that’s the future”*** and that ***“they might be willing to pay more and not mess about.”***

A trade-off remains between lease terms and covenant (AMgt05). Certainly demand from independents is growing and in a market where there are fewer “safe” multiple retailers looking for space landlords cannot afford to ignore independents. Good investment opportunities exist for landlords but knowing their tenants and the market in which they operate can help agents and owners take an informed gamble, perhaps not necessarily as high as once perceived (PMgt03, PMgt05). Increasingly more owners are prepared to do this, which marks a fundamental change in market practice although this might only be temporary and return to “norm” when the retail market recovers (AMgt01, AMgt06). As a result of these changes, independents, not just value multiple retailers with perceived weaker covenants, are appearing in prime locations you would not expect (AMgt01, PPS05).

### **Flexibility in the lease model**

Landlords are having to be flexible in the deals they negotiate with tenants and the area where malleability is most required is around lease terms. Six sub-themes emerge in the discussion.

#### **Lease length, break clauses, penalties and regearing**

Lease lengths are coming down. Before the pandemic, 10 years with a break at five was still achievable although there were already signs that deals were being signed at 3 or 5 years (AMgt02, PMgt01, PMgt02). Post-pandemic, the shift is more consistent where the majority of deals are now 5 (or less frequently 6) years with 3, 2 or 1 year breaks (AMgt03, AMgt05, PMgt03, PPS03) which compares with 94% of new leases recorded in 2019 being less than 15 years with the average unweighted full term (ignoring breaks) around 8 years in the retail sector (MSCI, 2020). The average is now lower although on strong pitches such as Buchanan

Street, Glasgow ***“you’re getting 15 years, 20 years there because the landlord’s in such a strong position”*** (PMgt01) while ***“a prime restaurant coming in [...] don’t want to write off their fit out over a short period, you know, they’ll take a 15/20 year lease.”*** (AMgt04).

Changes in the length of leases reflect the re-organisation of the retailing industry – more start up independent retailers who want an escape route in case they fail and established retailers requiring the flexibility to revamp/rebrand stores or downsize their physical store network. Break clauses, driven by tenants in pursuit of flexibility, have become more common in the last couple of years with tenants being more cautious about agreeing guaranteed terms for longer than 2 or 3 years (PPS15). This change was happening prior to the pandemic:

***“some retailers are looking for rolling breaks now, and it’ll be tenant-only breaks, it won’t be mutual, you know, the landlord will say, we’d quite like a mutual break – no, no, it’s tenant-only.”*** (PPS03, Glasgow, Pre-C19)

Landlords on the other hand still want security. As PPS01 highlights, ***“If [tenants] could get away with it they would want a break every year type of thing, so they don’t have that obligation on them. But there’s a point to what a landlord can’t give.”*** so satisfying both sets of expectations is ultimately an impossible trade-off. The longer term security landlords can gain from restaurant and leisure operators in specific locations or those who need to cover the write off of expensive fitouts has shifted owner preferences in favour of these tenants. However, this type of tenant tends to be rare outside ‘super-prime’ locations.

Juggling the two sides of a deal needs compromise (PMgt05). Break clauses are being used to offer some sort of basis in the negotiation process that allows both parties to offer terms that suit each other without impinging on their own requirements – ***“you might start off and say, well, I only want a three year lease or a five year lease, and the landlord will probably say, why don’t you take a ten year lease, but you can have a break clause at fifth year. Gives me a bit more comfort, e’hm although you may operate your break, but hopefully you won’t”*** (PPS11). The removal of conditionality around breaks (PPS07) is also transforming the landlord/tenant relationship ***“where there are leases with break options, we’re certainly getting [...] bigger tenants being quite proactive about their use of break options as well, either using it to get out of leases because they’re not trading well, or as a way to try and renegotiate with the landlord.”*** (PPS14).

### **Rent-free and other incentives**

Rent-free incentives are commonplace in the property market and as the market has weakened, landlords have had to give longer rent-free incentives to attract tenants - ***“it might just be something as simple as extended rent-free periods.”*** (PPS03). There is nothing new in this but with shortening lease length and greater use of breaks it is more of a balancing act - ***“if you say take a ten year lease you would be looking to get somewhere in the region of a two year package, whether that’s capital or rent free. Five year lease, you’d probably be looking at getting 12 months.”*** (PPS01). A number of respondents describe the scale of rent-frees being given away as staggering, and more likely to be offered to the national retailers rather than independents (AMgt06). Yet, packages offered by landlords include rent-free periods along with additional incentives such as capital contribution and assistance with fit outs in order to derisk deals for tenants (PMgt02, PPS06, PPS05). The value of some packages now being unsustainable:

***“So you can have a situation where for the five year lease you’ve got no rent other than the turnover, but you might have to pay away two years or maybe three years as a capital incentive to get the occupier to take the space. So economically, it just doesn’t make any sense.”*** (PortMgt01)

A change directly linked to the pandemic is the regearing of leases where landlords gave rent-free periods to support tenants during covid but in return for extending the length of their lease (AMgt04). This support is being offered in a hope or expectation that tenants will show appreciation when market circumstances change by remaining in occupation when leases end and/or incentives will come down at a future point. It is too difficult to see if landlords have taken an unrealistic gamble as ongoing uncertainty makes it impossible to see what degree of pricing power they will have in the future. Hence, being able to justify holding these investments is the challenge for owners and rests on the re-calibration of acquisition prices.

## Emerging turnover model

The dominant pricing method used in the UK traditionally set rent for a unit (quarterly in advance) at the open market rate with the unit measured on a Zone A basis but this is the area of greatest change as we are seeing a rise in turnover rents. Widely used in North America and mainland Europe, the data reveals the increase in the adoption of the turnover model in the UK.

Historically, turnover rents have been used in outlet parks, airports and some shopping malls - *“we’ve always worked in turnover rents and I know a lot of the landlords have for a long time at least worked in turnover top up rents”* (PMgt02) - but they started to become more widely used prior to the pandemic (PMgt02, PPS01, PPS02, PPS06, PPS04, PPS09) and identified in some high street deals with larger retailers - *“Yes, so the H&M turnover that I described earlier, that was in a high street unit shop”* (PortMgt01, Edinburgh, Pre-C19).

Across the five centres, the pace of adaption of turnover deals has accelerated in the wake of the covid pandemic (PMgt05, PPS09, PPS11) with *“the fashion industry for example is now, kind of, turnover leases only”* (AMgt06). The expectation in the market is that turnover deals will only continue to increase (PPS12). PPS09 in Nottingham says *“Retailers are the one that are leading the charge on that at the moment. Big box leisure operators who are looking at cities at the moment are likely to look at base and turnover deals”*, and PPS11 in Liverpool reports that he has *“done a couple of turnover deals in the last 12 months [...] both occasions actually, over to restaurant groups”*. Thus, some leisure operators are using but there is variation in practice.

PPS08 thinks that leisure operators more generally are looking *“at good net rent deals at the moment”*. The difference in preference is explained by PPS04 - *“it doesn’t really work so well on restaurant use. Because, unless you’ve got a cap, cap on it, or a collar on it. Because, you know, the restaurant market can, you know, you can trade your socks off as a restaurant operator and end up giving all your profits away to the landlord. It’s a, it’s a very precise model, and you need to get it absolutely right.”* Ultimately, the adoption by restaurants depends on the terms of the turnover deal.

AMgt05, who deals largely with independent retailers, says - *“Not in Hull. Again, turnover leases are popular within more prime retail, and within food and beverage. And we just don’t have that established market. [...] Yes, somewhere like Princes Quay is an example, or, or St Stephen’s, or an out-of-town retail park may use them quite heavily.”* PMgt05 confirms that larger retailers have driven the change which is beginning to trickle down to small operators - *“more forward thinking agents are probably explaining...putting that to the retailers and the retailers have perhaps not thought about it. [...] So when you introduce a turnover rent to those types of operators, it usually gets their ears pricked up because they like it”* (PMgt05).

Much of the change is tenant-led because tenants benefit most from it. Some academics believe that turnover rents and fixed rents ultimately should yield the same occupancy costs (Benjamin *et al.*, 1990) but retailers are also using turnover on a total occupancy cost basis with not much left for landlords after service charges and business rates are paid. Wheaton (2000) argues that a benefit of turnover rents is that they help retailers manage landlord’s opportunism and expectations. As tenants are typically hostages to the surrounding tenant mix, which the landlord is in greater control of, a turnover rent also encourages the landlord to tune into the tenant’s needs and makes for a *“much closer landlord and tenant relationship and a much more productive one.”* (PMgt04). Further, it provides retailers with *“that comfort if they have a really poor trading year, they’re not paying the top dollar in rental, and the landlord shares the pain.”* (AMgt01). This explains why some retailers, for example JD Sports, are happy to enter into a turnover agreement that results in them paying a higher rent than they would have under an open market rent (AMgt01). The downside of sharing tenant/landlord risk is that the landlord’s income is more unpredictable, something which lenders are uncomfortable with.

In standalone high street units, where owners do not own adjacent units and have little influence over tenant externalities, there is less evidence that retailers can benefit in this way from turnover deals (Wheaton, 2000) but they have been increasingly in use since 2019 - *“The likes of H&M, for example, they tend not to take leases on a straight rental basis anymore”* (PPS07). Smaller landlords *“can’t do anything about retailers’ turnover. They’ve got no experience of retail, they own one shop amongst 65 owners in a one square mile of the city centre. What can they do to make a difference?”* (PPS13) so rather than motivating landlord, this

switch seems to be more about lowering the retailer's exposure to fixed overheads during uncertain trading periods and sharing risk (PPS03, PPS07).

There has been, in the past, resistance to turnover rents by landlords (PPS06, PPS05, PPS01). PMgt04, who manages a shopping mall in Hull, said just pre-pandemic they have ***“two in the scheme and I've got 52 units, so they try and steer away from it if possible”*** (PMgt04). The concept appears, on the surface, reasonable enough in that landlords will share in the successes of their tenant but will support them in times when they are struggling. In practice, the perspective is that landlords are losing out from the application of turnover rents and respondents indicate that some landlords remain resistant to them :

***“Landlords hate them, absolutely hate them, yeah. No, never, never done one and I'm not sure I'm going to be doing one. The landlords I act for are absolutely opposed to it.”*** (AMgt03, Nottingham, Post-C19)

Typically ***“landlords just want straight rents but they're not getting them anymore”*** (PPS05) and a key issue associated with turnover deals is the lack of guaranteed rent which pushes down the value of their investment (PPS01). Other reasons given are their complexity, inexperience of some landlords and lack of transparency in terms of capturing turnover (PPS03, PPS04, PPS07, PPS08). ***“In centres, it's easier to keep track of that, you know, through the EPOS system and the way it all comes together. On high streets, it's much more difficult.”*** (PPS03) – a point also raised by PPS04 and PPS07. PMgt02 advises that his clients have ***“got a fairly sophisticated reporting system in place”*** although AMgt02 who has experience dealing with turnover rents in shopping malls highlights the difficulty in policing:

***“how do you police that? Because all we're reliant on is the auditor's letter. And I don't necessarily think that the, the, the auditors that are giving us these numbers...being completely honest with you, I don't think they really understand the provisions of the lease.”*** (AMgt02, Glasgow, Pre-C19)

Problems also exist with leakages in turnover deals as online sales, which might originate in-store, are typically excluded from the sales revenue associated with the physical store. Click and Collect, viewing and trying-on are common in-store activities that leak from the store as the actual transaction takes place online. In addition to this, retailers deduct online sale returns to stores from their total in-store sales revenue, so the leakage can have a double counting effect (PMgt01, PMgt02, PPS13). Hence, the method of determining the gross or net sales made by a store needs to be re-examined with better accounting of online leakage, as highlighted previously by Yuan and Krishna (2008). This is a particular issue for showroom stores where retailers are increasingly free-riding their internet sales off physical stores. PPS13 highlights taking ***“postcodes that are in a five mile radius of the store and any internet sales in that postcode, 50 per cent get attributed to the store”*** might be a workable solution to capture the halo effect of a store.

There is general agreement that a standard definition and measurement for turnover is needed although the point - ***“we have a turnover clause that was written ten years ago, that, that clause doesn't anticipate where we are now. And we've had a fallout with retailers over things like online returns, what can you...what, what is included in gross turnover, what isn't and what can you take off it and what can you not. So that's something that we've seen emerging.”*** (AMgt02) - suggests this definition would need to be reviewable to capture technology driven changes in the market.

The evolution of the turnover model in the UK retailing appears to be structured around two components: a percentage overage based on the sales revenue of the retailer located in the store and sometimes a fixed base rent - ***“sometimes there is a base, sometimes there's not”*** (PortMgt01). PPS05, pre-pandemic advises that ***“there's not really one size fits all, but we are seeing more, there does still tend to be more of a base rent, and then a turnover top up.”*** The base, pegged to the market rent or a previous level of rent, guarantees a level of income for the landlord and is also appreciated by valuers as they have a basis for valuing a fixed income stream. Threshold turnovers can exist in some deals but PMgt04 identified past problems:

***“you're finding the teams within those units are not driving the sales [...] I'll be going in as the centre manager and saying, right, I've noticed this, this, this and this, which I shouldn't have to [...] motivate the teams in order to provide the customer service, to increase the turnover [] because obviously the landlord gets their cut. And we find that, you know, the***

*companies behind these are not doing that. They want to make their bit but they don't want to actually give landlords any more money, which is bizarre*" (PMgt04, Hull, Pre-C19)

The base rent *"could be 80 per cent. Sometimes it goes as low as 60 per cent but in the main it's 80 per cent, what is perceived as being the open market rent"* (PPS05, Edinburgh). PPS11 (Liverpool) insists *"I've never seen 100 per cent turnover."* although AMgt02 (Glasgow) claims *"actually based on turnover too, so not even a guarantee of a fixed rent is what retailers are coming to us with. [...] to get the right brands in, you would definitely have a long hard think about it. [...] So total turnover, yeah."* PPS04 (Hull) concurs with AMgt02 *"Yeah, it could be a base on a turnover, or just a straight turnover. The movement, I think, is possibly more towards turnover-only"* but there does not seem to be any city pattern as to the use of 100% turnover.

There is also considerable variation in the percentages on turnover being agreed. *"The percentages, it could be four per cent, it could be 20. It depends who it is and why and what you've given them at the start and what the incentivisation is. It's a whole bunch of different negotiations and a whole bunch of things that come together to try and end up with a deal."* (PPS05). *"If it's turnover-only, obviously it'll be larger"* (PPS03) and *"the food guys tend to pay higher percentages than the out and out fashion guys"* is the experience of PPS14 when there is a turnover top and a base rent around 80% of ERV. The tendency to use operator specific terms is confirmed by PPS13 who reports *"the percentage will change depending on the retailer's margin. So a coffee retailer should pay a bigger proportion of turnover because their margin I think is better"*.

No single, set system of percentages or fixed model exists in terms of the base or top up as they tend to be set on a deal by deal basis. Hence, transparency is an issue - *"They're just too opaque [...] they don't mean anything"* (AMgt03) - with no known requirement for the 'anonymous warehousing' of turnover rents, say in the form of an MSCI arrangement, where agreed terms can be benchmarked, enabling landlords or tenants to evaluate whether, on average, their terms are fair. Without accurate measurement, or standardised definitions, there is always going to be an element of guesswork, but if these more flexible lease terms are to gain the confidence of landlords then there has to be an acceptable form of measurement.

The mechanics of turnover rents are relatively new, in most instances, to landlords, tenants, agents and valuers in the UK retail property market and there appears to be no best practice or established approach to the different elements determined within the turnover lease. At the simplest level, it is not obvious how turnover percentages reflect the dynamics of the retailer's operation. Maybe the turnover percentage is set in terms of how the premises contribute to the overall cost of serving the consumer, or perhaps the percentage is based on total revenue earned in the unit or its profit margin but this is not clear. This is before even considering the issue of trust associated with turnover deals as the provision of evidence to the landlord does not always rely on professionally audited figures, although landlords often have the option to request independently certified accounts if they are concerned about the reliability of figures (AMgt02).

### **TOC and rent inclusive of cost leases**

Traditionally rent in the UK was paid by tenants net of business rates or service charges but landlords have had to be flexible as the market is seeing a rising trend in the adoption of Total Occupancy Cost (TOC) leases where rent is inclusive of service charge, rates and possibly insurance. The rent agreed might be a fixed rent, set by the tenant's budget for all occupancy costs, but TOC can also be *"based on turnover too, so not even a guarantee of a fixed rent is what retailers are coming to us with"* (AMgt02). Nine interviewees report that they have had some experience of this relatively recent change. PMgt05 sums up the consequences - *"tenants more often come along and say, I've got X pounds to spend on everything, what can you do? And the landlord has to do the hard work in the background about splitting that between the business rates, the service charge and...is there any rent left?"* Interviewee PPS04 identifies TOC, prior to the pandemic, as typical of shorter/temporary leases.

As well as the increased administrative burden, this has a major impact on the bottom line. Arguably, landlords are justifiably having to offer more to their customers, having had things lopsided in their favour for too long but participants quote examples where zero or very low rents are the result of this market shift.

## Shifting repair obligations

The traditional FRI model is increasingly becoming irrelevant in respect of UK retail property. Tenants are no longer willing to take on onerous repair obligations such as FRI terms that have long been a staple of the UK market. It's perhaps an inevitable consequence of shorter leases but retailers will no longer take on repair and dilapidation obligations (PPS08, AMgt02):

*"I'll take some repairs but I'll, let's exclude that and let's exclude that and, you know, I want the positive obligation the other way round so you do it, not me"* (AMgt03, Nottingham, Post-C19)

It would be reasonable to argue that this is a path to a more rational relationship between owners and occupiers. Landlords now have to offer something to tenants to entice them take on repairing obligations, particularly in areas of the building not essential to the operation of the occupier's business. Yet, this shift is not uncommon in market downturns - less onerous terms tend to be where the landlord has traditionally been flexible but with the market reverting to FRI as market conditions improve.

## Outdated clauses and emergence of alternative terms

Upwards only rent review clauses are now seen as outdated and continue to be squeezed out of the market. Discouraged by *The Code for Leasing Business Premises in England and Wales 2007* (RICS, 2007), it is surprising to see it raised as an issue. *"upwards only rent review is not going to happen. You're not getting an uplift. Where's the evidence? But that...the clause, the clause is really outdated."* (AMgt02). Many existing tenants have been stung in the past with these clauses which are a *"real issue for a number of tenants who are locked in on long term leases as upwards-only rent reviews on a twenty year lease and they just have a completely historic rent paying, you know, double what the adjacent tenant is paying. [...] That's probably a reason why we've seen so many CVAs over the last year"* (AMgt03).

Three interviewees report there has been a rise in requests for index-linked rent review clauses by food operators. One agent suggests the use of *"a geared rent review to RPI or CPI with a cap and collar, which I think has got a place in the market [...] it can help the tenant, so, so that rents aren't increased e'hm by too great an amount as a result of market activity"* (PPS11). There are tentative moves to indexation, in retail parks and by F&B operators, but it still limited in practice.

Redevelopment clauses are commonplace with independents (national retailers will not accept), particularly in shopping malls, where they allow the landlord to break at any time to under redevelopment work. There is also a general rise in tenant-led clauses:

- *"pandemic clauses in almost every lease is something the landlords are also having to adjust to."* (AMgt06) although some landlords have *"rejected it because of banks and, yeah, they may not let them continue to loan on, on the property"* (PPS15).
- CVA clauses are emerging. *"So the likes of Next [...] they want a CVA clause in there [...] If someone else does a CVA and their rent goes down, their rent drops with it"* (PPS03) although these are easier to exercise in retail parks where rents are not based on Zone A rates.

Adjacency clauses are also growing in popularity where occupiers want control over the tenants they are located in close proximity to. Some tenants do this to control their brand by blocking certain neighbouring uses (PortMgtg01). Other adjacency clauses are used to ensure location next to a specific retailer (PMgt04). One conclusion that can be drawn from the clauses and other flexible terms emerging now from landlord and tenant negotiations is that leases are becoming ever more bespoke and complex.

## DISCUSSION AND CONCLUSION ON THE ADAPTATION OF THE RETAIL INVESTMENT MARKET

The area in the retail investment market that has undergone perhaps the greatest adaptation has been the lease model. The length of leases have steadily shortened to 5 year terms with tenant-led breaks at 2- or 3-years being the current norm. Shorter temporary leases, particularly in the wake of the pandemic, have also become popular in areas with high voids and yearly breaks are not unheard of. Landlords still crave the security attached to long leases, and this behaviour explains the popularity of hospitality and leisure operators as these occupiers

tend to be more comfortable with longer leases to spread the heavier costs associated with their internal fit-outs and time required to build a solid customer base.

Affordability has been driving deals in the market and rents have been rebased as a consequence, nervousness around voids and tenant defaults have pushed yields up, leading to a rebasing of investment prices which has attracted the attention of opportunistic buyers (PMgt01, PMgt05, PPS03, PPS09, PPS15). Drops in value have been experienced, even before the pandemic, for some shopping malls that are almost beyond comprehension (AMgt01, PMgt03, PMgt01, PPS05, PPS08, PPS13). In some instances, the fixed burden of business rates and service charges means landlords are having to slash rents to unsustainable low, or even zero, levels, which is encouraging more landlords to repurpose excess retail space and in time will correct the demand and supply imbalance. Over-renting is not uncommon in existing leases and it is understandable that unconditional tenant-led breaks are being used to lever better terms in over-rented properties while some retailers are perceived to be exploiting CVAs to escape their commitments to pay above market rents.

In parallel turnover-linked rents, a trend that emerged before covid, have grown in popularity despite resistance from landlords. These look set to stay although suburban high streets that attract independents and smaller operators have been much slower to adopt these changes. The complexity, lack of transparency and reliance on tenants, who have historically not been keen to share information on their performance, are the key factors that make landlords nervous. This is more pronounced when they have limited experience of the turnover model or supporting occupiers within their operation. The absence of a standard approach to measuring and setting the different provisions within the turnover lease is not helping the situation. Here, the property industry, which ultimately relies on information, needs to catch up, possibly by providing industry benchmarks to enable landlords or tenants to evaluate whether, on average, their terms are fair. Industry standards on how to define turnover, whether net of VAT, with or without deductions for returns and allowance for online sales linked to a store would also help remove some of the guesswork.

Confidence in covenant strength also appears to have been shaken over the last five years by the sudden collapse of perceived 'strong' multiple operators, the scale of CVAs in the market and improved financial position of 'weak' retailers. One area that seems to be changing, at least for open minded landlords, are perceptions around independents. This is a step in the right direction but what is currently unclear is if landlords are only taking a 'temporary' view on covenant to plug the gap in the market. Regardless, the accurate pricing of covenant into investment yields relies on a better understanding of an independent's financial position and potential of their business operation but the market nervousness around default risk are not helped by the financial data held by credit assessment companies. These remain the traditional means of assessing covenants, not being updated in real-time but recent innovation in the banking sector might help here.

The resultant changes in lease lengths, rent setting process and covenant strength, over-renting, more frequent breaks, non-payment of rent and the growing adoption of turnover models have significant implications for the valuation and appraisal of retail assets. These currently rely on the traditional income method that struggles to handle unusually cash flows, and breaks down when good evidence from transactions is limited in thin markets. The move away from Zone A rents to overall rates per sq ft and turnover-linked rents, and the difficulties with pricing default risk also undermine the basic inputs in the traditional retail valuation process. At the very least, valuation practice in the UK needs to adapt to turnover-linked models and the profits method offers a sensible adaptation to the retail valuation model. Yet, this does not deal with the lack of comparable evidence or cashflow complexities so a better way forward for valuers might be the adoption of a discounted cashflow model. Widely used in markets outside the UK, these contemporary methods are flexible enough to handle volatile and complex cashflows, and more transparent and realistic income assumptions might also prevent rent-free incentives or vacancies being 'abused' to inflate valuations. Yet, the switch will not be easy in an industry that has resisted this change for decades. It will require revised data collection, analysis and valuation processes to be put in place while education providers need to ensure graduates entering the profession are competent in application of these methods.

Identifying the pressing need for the property industrial in the UK to adapt further by changing its retail valuation practices is possibly the greatest implication of this research. Issues also remain regarding the assessment of covenant strength and transparency of turnover deals which require greater openness in the market and data sharing. The retail markets outside the UK manage to overcome these transparency, trust and valuation issues but a cultural shift is required in the UK. Innovations, like the sharing of real-time financial

data via Open Banking or creation of benchmark metrics of turnover-linked terms, might also help build confidence in turnover models but the valuation model still needs to be overhauled if the systemic market mispricing is to be addressed. To move this forward, the RICS as the governing professional body needs to take the lead here by undertaking a systematic review of best practice in other countries and in consultation with practitioners, investors and lenders to establish an appropriate retail valuation model, and to identify ways to improve transparency and data sharing in the market.

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Figure 2. Hierarchical Coding Tree

