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Real Estate

Retail landlords and tenants
– friends or foes?

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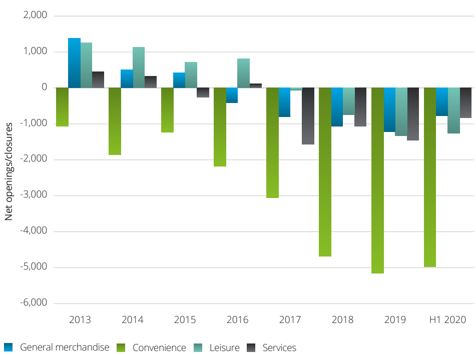
The relationship between retail landlords and tenants in the UK is under unprecedented strain. In addition to the structural shift to online shopping, which had already profoundly affected the High Street, the COVID-19 pandemic, and the associated forced store closures, has piled on further pain (see Figure 1). The current wave of retail closures and occupier requests for rent concessions has transmitted the pain from retail tenants on to their landlords.

Figure 1. Changes in occupation across the four main classifications (convenience, general merchandise, leisure and services)



Source: Local Data Company

The situation on the High Street has exposed the conflicting strains facing landlords and tenants alike. With retail sales from physical stores plummeting or even non-existent, the British Retail Consortium (representing retail occupiers) called for an extension of the moratorium on landlords taking action against tenants.

This was extended until the end of March 2021 and there is growing speculation this may be rolled over for a further three months for some sectors.

The British Property Federation, representing landlords, argues that the moratorium should be lifted to avoid tenants being incentivised to avoid paying their rents. The government's COVID-19 Code of Practice differentiates between those tenants who cannot pay and those who, using the pandemic as an excuse to preserve cash, are capable of paying but have opted not to.[1] Whether due to the Code or not, there is evidence that the current situation is encouraging tenants to engage with their landlords in a dialogue to restructure rents, and of landlords opening a constructive dialogue with tenants as both sides come to terms with the fact that they are in business together.

In recognising their shared interests, the traditional landlord and tenant relationship, and underlying financial model, looks set to evolve to better align the interests and risks of both parties albeit with considerable pain being felt by all as it develops. Principally, this appears to be taking the form of a very rapid shift away from fixed rents to a turnover model.

The fixed rents problem

Historically, commercial rents in the UK have been fixed annual commitments across a defined lease period. Rent-review clauses typically specify the rent to be appraised every five years, and that it can only increase—so-called 'upward-only rent reviews', although these clauses have had less and less relevance in recent years as the extent of over-renting has become more apparent. Retail landlords and tenants have historically typically agreed rents by reference to the prevailing 'tone' i.e. allowing the highest rent paid in a given location set the price for any other space available in that location – regardless of the retail use (and margins) that space might ultimately be used for. The agreed 'tone' has, in turn, set the evidence base against which rent reviews, lease renewals and, indeed, business rates are set.[2]

The problem with 'tone' is that it is set at a point in time. It does not easily allow for changed circumstances for a particular pitch at rent review or lease renewal. Nor does it flex to accommodate other cost pressures that affect occupiers. The shift to online retail has reduced sales from bricks and mortar shops. This trend has been exacerbated by more margin-eroding headwinds, including rising minimum wages, apprenticeship levies and the post-EU referendum decline in sterling, which sent stock prices higher. The old rent model is now too inflexible and out of date for most locations.

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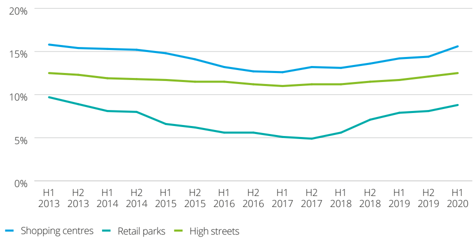
Figure 2. Vacancy rate by location type



Source: Local Data Company

Turnover rents as a possible solution

In the UK turnover rents have found favour in certain formats, such as outlet centres, but there has been resistance to more widespread adoption. Overall, landlords have been reluctant to commit to this type of leases, given the increased business and commercial risk associated with the terms. Moreover, turnover-based leases demand more hands-on asset management on the part of landlords to maximise footfall and 'turnover' and, therefore, rent.

Regardless of landlords' historic reluctance, tying rent to a tenant's trading performance has the advantage of better aligning the interests of landlord and tenant to mutual benefit. For example, while the landlord receives a lower rent in a downturn they share in an 'equity-style' upside in the good times. Equally, such an approach should help tenants to navigate the ups and downs of market cycles, hopefully reducing the risk of tenant failure, and the consequential impact on landlords of having to pay business rates on empty properties, reduced visitor appeal and increased irrecoverable costs.

As turnover lease models develop, landlords are likely to be more interested in the tenant's performance at the premises. Landlords might insist on the inclusion of specific tenant covenants to increase their control over the tenant's operations and improve visibility on performance, such as demanding timely data flows from which to calculate rent balances. This increase in transparency would also provide landlords with more 'early warnings' of when a tenant is starting to struggle.

Landlords are also likely to require more transparent and negotiated trading forecasts, enabling the parties to predict trading more accurately and agree sustainable levels of turnover. The turnover model may well drive shorter leases and provide landlords with more opportunities to break leases where tenants are failing to deliver the required level of turnover. A consequence of this is that tenants may well find that they start to sign away the protections of security of tenure they have always enjoyed courtesy of the Landlord and Tenant Act 1954.[3]

Margin or hybrid rents?

There is an argument that margin-based rents are a fairer solution than turnover-based rents, as margins differ between sectors and individual retailers. The challenge here would be for the parties to define and agree the complex calculation of what rental margin is likely to be affordable to the occupier, while also meeting landlords' return targets.

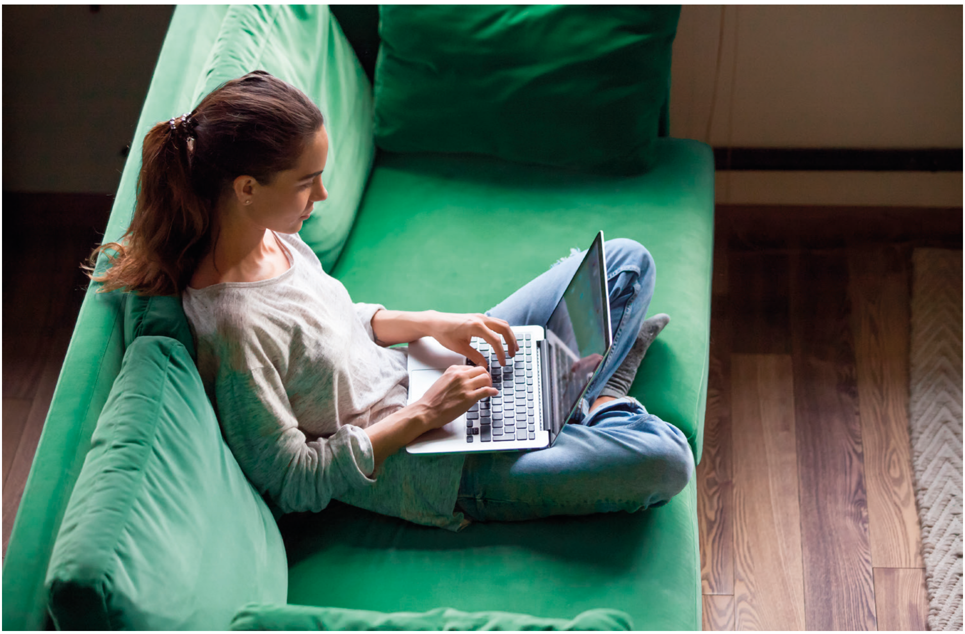
Some landlords might prefer a hybrid model, with a base rent plus a turnover top-up. This offers the landlord a degree of income security and predictability. A hybrid model moderates the risk of the debt not being serviced and of significant valuation fluctuations. Nonetheless, in the past there has been a tendency for the base rent to be set too high, so much so that the turnover element has frequently failed to take effect.

"Some landlords might prefer a hybrid model with a base rent plus a turnover top-up."

Multi-channel retail complicates matters

Online retail has been one of the biggest hurdles to the development of turnover rents. E-commerce has clouded the role and profitability of individual stores. How can landlords value the role of physical stores—as product and experience showrooms, bases for 'click & collect' services and convenient product return processes—where many of the sales are executed online?

As landlords seek to maximise turnover rent, they may demand that online sales, 'click & collect' and return services be factored into the calculation. Retailers will likely seek to retain online sales revenues, though this needs to be balanced with the business need to maintain their brand presence in key physical locations. In many cases, landlords will need to accept that the margins achieved online and through 'click & collect' sales are much lower than through in-store sales, making a one-size-fits-all turnover percentage impractical.



Valuing turnover-based assets

Valuers face a significant challenge in adapting to widespread adoption of turnover-based leases. It arguably renders the traditional 'Zone A rental tone' analysis approach obsolete – but against what benchmarks can valuers then be comfortable as to the rental value potential for a unit? If such a unit may be occupied by any number of a range of occupiers, will each have a different affordability threshold? Further, the analytical skills of a valuer will need to evolve – as they have done for many 'alternative'-style assets, the value of which is predicated upon trading potential, in order to assess the business performance of retailers.

Open, transparent and timely information flows will be critical to valuation and to confidence among investors. Hitherto, turnover-based leases have often been discounted due to perceived uncertainty. Accordingly, as valuers put themselves in the shoes of investors, they will wish to build confidence in respect of the predictability and reliability of trading information in order that they can confidently form a judgement as to relative risk.

With turnover-based leases in their relative infancy, the availability of benchmarks and market comparators is scarce. This, compounded by the dramatically-reduced liquidity levels caused by both major structural change and the effects of the pandemic, will inevitably lead to continued near-term challenges for valuers as they seek to best interpret the market.

Nonetheless, it is reasonable to expect valuers to adjust and adapt to the evolving market dynamics with judgments informed by real-time soundings garnered from the full range of stakeholders.

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Should lenders modify finance debt arrangements?

Turnover, margin or hybrid rent solutions, compared with more traditional fixed rents, will shift the balance of financial risk between landlord and tenant more towards the landlord. Banks may face an increased risk of missed payment from landlords given the higher income volatility. This will require banks to rethink the approach to assessing lending proposals and counterparty credit risk where payment is wholly, or largely, dependent on the rental income from the tenants occupying the underlying real estate. The financial strength of landlords, independent of rental income, is becoming more important and new facilities may need to be considered to address the higher income volatility.

Solutions such as 'equity style' and potential for shorter, less secure leases will result in higher income volatility. This additional risk will likely need to be reflected in higher risk premiums as well as a different form of risk-reward where the volatility risk is shared more equally between the tenant, landlord and lender. There may also need be more flexibility in timing of repayment to reflect variable income from lending to landlords.

Lenders will need to consider a more nuanced approach to assessing credit risk that places greater emphasis on the stature of tenants and their capacity to repay, tenant spread, sector outlook, alternative demand, and local market dynamics and competition. The more hands-on asset management expected from landlords will necessitate a similar hands-on approach from banks. The ability to better negotiate contractual terms such as base rent in a hybrid approach will put tenants in a stronger position thereby threatening cash flows and the landlord's debt serviceability.

Enhanced analysis for originating and monitoring transactions with heightened rental income volatility will prove to be costly for banks. Challenges for landlords with ensuring accurate and timely capture of tenant data such as turnover will present similar challenges to banks in controlling their exposure. Banks will need to consider how covenants with landlords be amended to address some of these challenges as well as to ensure that landlords are maintaining healthy relationships with tenants. Requirements for director guarantees and other forms of security may need to be enhanced to provide additional comfort to the bank in entering into transactions. Banks will also need to consider the implications of valuing turnover-based assets given the impact on the market value of the security.

The higher income volatility, credit risk and operating costs for managing exposures with landlords will require banks to reconsider their approach. Well executed transactions can, however, present upside for banks through higher income and opportunity as well as lower defaults as a result of more diligent underwriting and hands-on management.

In summary, there are a range of actions banks need to consider in relation to their landlord-based lending.

1. The credit underwriting process will need to be reassessed to capture:
    a. Greater focus on the financial health of the landlord;
    b. Greater analysis on the financial health and profitability of the tenants;
    c. Consider use of stress testing and scenario modelling at different profitability and therefore rental values and likely impact on loan servicing;
    d. Changes to covenants; and
    e. Additional data requirements from landlords on the performance of their tenants and providing this to banks.

2. Portfolio management capabilities will need to be enhanced including:
    a. Enhancements to early warning systems;
    b. Provision of more granular data to banks; and
    c. Closer look at sector limits and sector monitoring of tenants.

Creating retail destinations

The shift towards online shopping exacerbated by COVID-19, means that many High Street retailers will face a challenging recovery. Faced with reduced income, increasing vacancy costs and legislation preventing them from taking enforcement action, retail landlords are struggling too. There is a larger discussion of these trends in Deloitte's latest *Future of the High Street* report.[6]

Whether the industry continues to gravitate towards turnover rents or reverts to a more traditional model, two things will remain unchanged for landlords. Supply and demand will dictate the terms and proactive asset management, which is alive to evolving retail, leisure and, indeed, demographic trends will be key to asset performance.

Endnotes

1. Code of Practice for commercial property relationships during the COVID-19 pandemic, Ministry of Housing, Communities & Local Government, June 2020. See also: https://www.gov.uk/government/publications/code-of-practice-for-the-commercial-property-sector

2. https://www.gov.uk/introduction-to-business-rates

3. https://www.legislation.gov.uk/ukpga/Eliz2/2-3/56/contents

4. https://www.gov.uk/company-voluntary-arrangements

5. Bank of England measures to respond to the economic shock from Covid-19 | Bank of England, 11 March 2020. See also: Bank of England measures to respond to the economic shock from Covid-19 | Bank of England

6. What next for the high street? Deloitte LLP, January 2021. See also: https://www2.deloitte.com/uk/en/pages/consumer-business/articles/what-next-for-the-high-street.html

Contacts page

Real Estate Insights

Margaret Doyle
Chief Insights Officer & Partner
+44 20 7007 6311
madoyle@deloitte.co.uk

Bo Glowacz
Real Estate Insight Lead
+44 20 7007 5105
bglowacz@deloitte.co.uk

Deloitte Real Estate

Siobhan Godley
Deloitte Real Estate Leader, Real Estate Tax Partner
+44 20 7007 2745
sgodley@deloitte.co.uk

Real Estate Consulting

Hugo Clark
Director
+44 20 7007 3584
huclark@deloitte.co.uk

Valuation, Assurance & Professional Advisory

Philip Parnell
Partner
+44 20 7303 3898
pparnell@deloitte.co.uk

Audit & Assurance

Philip Doherty
Partner
+44 20 7007 7949
philipdoherty@deloitte.co.uk

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