IPF

RESEARCH

DECEMBER 2021

Turnover-based Leases

Issues, Drivers and Challenges: A Survey of Current Practice

FULL REPORT

COMMISSIONED BY THE IPF RESEARCH PROGRAMME

This research was funded and commissioned through the IPF Research Programme 2018–2021.

This Programme supports the IPF's wider goals of enhancing the understanding and efficiency of property as an investment. The initiative provides the UK property investment market with the ability to deliver substantial, objective and high-quality analysis on a structured basis. It encourages the whole industry to engage with other financial markets, the wider business community and government on a range of complementary issues.

The Programme is funded by a cross-section of businesses, representing key market participants. The IPF gratefully acknowledges the support of these contributing organisations:

Turnover-based Leases – Issues, Drivers and Challenges: A Survey of Current Practice

Report

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Turnover-based Leases – Issues, Drivers and Challenges:
A Survey of Current Practice

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The move towards turnover-based leases has been widely reported, though with little accompanying analysis of the variation in their terms or the motivation behind their use.

This research sought to identify the relationship between fixed base rent and turnover-based rent components, the variation of their use by sector, and to ascertain whether turnover-based leases are a short-term market adaption in difficult economic circumstances or a growing trend that will become a more common feature in the UK market.

A second objective was to discover whether current valuation models have been able to adapt to turnover-based leases or whether a different model needs to evolve, drawing on parallels in continental European and North American markets, where turnover-based leases are more common. If a new valuation model needs to be adopted, what turnover element should be assumed, what discount rate should be applied, and what datasets are available to support valuations?

An additional objective was to consider the implications for the calculation and interpretation of published yields and rent series.

A further report will focus on the implications of turnover-based leases for the calculation of worth.

Findings

- With contributors to the research overwhelmingly reporting the increased use of turnover rents in the UK was confined primarily to the retail sector, all reported results have been restricted, therefore, to the retail and leisure categories: high street, retail parks, shopping centres, leisure and restaurants/F&B.
- The data supplied by owners found that turnover-based leases account for around 8% of all retail leases and about 15% within shopping centres.
- Valuers, agents and owners were unanimous in their belief that turnover rents were now standard lease terms in shopping centres for some retail uses, such as fashion.
- Several respondents believed that for single occupancy out-of-town and retail parks, turnover rents were temporary concessions to lease vacant units and/or a response to a restructuring (including CVA), rather than a structural shift.
- Occupier resistance to turnover rents was widely mentioned, due to a reluctance to share turnover data, particularly outside of the fashion sector. The main reported motivation from occupiers for turnover-based leases was as a means of reducing occupational costs, reducing the rent liability recorded on the balance sheet and managing the potential for further declines in turnover due to rising internet sales. For landlords, turnover-based leases were a means to re-base rents lower, to collect some rent in a distressed market, and to benefit from a subsequent market recovery once these rents have been re-based.
- A turnover-based rent, as opposed to a fixed base rent, per se, was not cited as a means of increasing rental income but, instead, as a way to reduce the risk of tenant insolvency, as the payment requirement would decrease with a downturn in sales. Conversely, it would increase if sales were increasing. Thus, there would be an increase in income volatility, relative to fixed rents, but countered by the increased potential of retaining tenants in downturns.

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- This was reaffirmed by many investor respondents citing that the combination of turnover data and the choice of operating with leases outside the Landlord and Tenant Act 1954 helped to deliver both higher income growth and reduced tenant insolvency risk, without the penalty of higher income volatility. This may seem counterintuitive as the uncertainty of a turnover rent would normally increase income volatility but this is offset by the increased ability to manage the lease and the tenant mix overall.
- Respondents highlighted the shift to turnover-based leases had coincided with a dislocation between the affordability of rents and store-based turnover, and that for turnover-based rents to align with affordability will require a modification to the definition of turnover, primarily to include store halo effects on online sales.
- Valuers noted two valuation models at their disposal: the implicit capitalisation model, which accounts for all expected growth and risks pertaining to the investment, with adjustments of a single capitalisation rate (the all-risks yield or ARY) relative to rents expressed in today's terms and, in contrast, the explicit, discounted cash flow (DCF) model, which applies growth to the projected cash flow that is then discounted at a required rate of return without any growth adjustment in the yield.
- Across continental Europe, valuation of shopping centres using the DCF explicit model was reported as standard practice. In the UK, growth explicit (DCF) valuations were only found to be confined to a cross check to the implicit valuation model for shopping centres.
- Valuers were frank about the difficulty of estimating the Market Rent and Net Effective Market Rent in current market conditions, particularly as the components of the Net Effective Market Rent were not explicitly known from comparable data. Despite this, the standard cash flow assumption remained a reversion to Market Rent at the next break or lease expiry.
- Variations in the yield applied to the turnover and base cash flow slices (using the implicit model) were significantly down-played due to the assumed de minimis value of the turnover-based rent element. As comparable yield evidence was similarly based on centres generating an assumed minimal turnover income, little impact was expected on the resulting valuation.
- For the explicit valuation model, the majority of respondents assumed growth in the turnover element. Property level adjustments could occur where the valuer made specific assumptions for each unit before aggregating the valuation.
- Valuers reported resorting to spreadsheet valuation models for the explicit valuation, and either using already modified generic or new generic software, or had plans to do so in future for both the explicit and implicit valuation.
- Valuers emphasised the need to understand the affordability of rents to the current occupier, their past turnover and future projections. Despite this need, such data was not widely provided or known.
- To convert leasing evidence of a turnover-based lease of a comparable store into a comparable Market Rent requires an understanding of the (likely) turnover achieved, whether based solely on the store or similar stores, and by occupier type. Despite this, no external datasets were cited of turnover trends by occupier and property type in the UK. A few respondents thought that this may be available in America and Canada, albeit the responses from the North American-based respondents suggested that these markets were not using 'percentage leases' as much as their UK colleagues envisaged and, as such, there was no external dataset available there either.

EXECUTIVE SUMMARY

Implications

- It is likely that a proportion of the move to turnover-based leases will be reversed as the UK economy emerges from the pandemic. The research found that this was most likely in single occupancy out-of-town and retail parks and least likely in shopping centres.
- Further striation of retail leases is anticipated. For some, turnover-based leases will become the norm (for example with national and international fashion and F&B) whilst other occupiers will revert to fixed rent leases. In the sectors where turnover-based lease do become more readily adopted, the mechanics, procedures and data flows of property markets and information providers will need to adapt rapidly to reflect a higher proportion of turnover-based leases.
- An issue has arisen with rent agreements during the last 18 months, with many quoted on a net rent basis, whereas often units are being let on a gross rent basis, which covers costs such as rates and service charges. These non-recoverable costs need to be deducted from the quoted rent to derive a true net rent.
- The standardisation of definition(s) of turnover in lease contracts will lead to greater ease in their adoption.
- The more transparency of retailer turnover there is to valuers and investors, and on general retailer turnover to measure net and gross effort ratios[1], the less uncertainty there will be around valuations.

What happens next?

- Assuming such transparency is achieved, the standard valuation model would be expected to move to an explicit (DCF) model for certain types of retail assets, particularly shopping centres. This approach will require assumptions for growth in the turnover and also Market Rent.
- Market datasets will need to adapt and report trends in retailer effort ratios by retailer category and property type (similar to that in existence for hotels).
- Valuers will need a lot more data on retailer turnover by category/scheme type and it will need to be verified and benchmarked. Anecdotal evidence is just simply not sufficient or robust. Either, specialist valuers must emerge that have access to data on turnover levels by retailer category and scheme type/location or third-party data intermediaries will emerge.
- Market yields can still be computed on a no growth basis, with reversion to Market Rent at lease expiry or break if over-rented (this is the current MSCI methodology). However, there is a significant problem with assessing Market Rent and this needs to be addressed before market yields can fully reflect the changes in retail investment.
- Prime net initial yields should be quoted net of (estimated) non-recoverable costs and inclusive of (estimated) turnover, with these assumptions published alongside.
- The calculation of market rental value growth is unaffected by the move to turnover-based leases. But additional series are required on the key terms of a turnover-based lease and the turnover rent paid (as a percentage of rent) in order for capture the expected turnover element of the rent.

1 The ‘effort ratio’ is commonly referred to as the rent paid by the retailer as a percentage of their total net sales.

1. INTRODUCTION

As turnover rents have been a feature in an increasing proportion of leases, the overall aim of this research has been to identify the extent of their use and whether there is a definable consensus on the relationship between the fixed and turnover components and a variation of their use by sector. The research has also sought to determine whether turnover-based leases are a short-term market adaption in difficult economic circumstances or a growing trend that will become a common feature in the UK market.

The use of turnover rents presents a number of valuation questions when determining market value for such assets, including:

- What turnover element should be assumed and what discount rate should be applied in the valuation model adopted?
- Are current valuation models able to adapt to turnover-based leases or will a different model evolve?
- How do UK valuers currently undertake market valuations and what datasets/comparable evidence are available or are being compiled for valuers?
- Are there gaps or deficiencies in the data available?
- Can parallels be found in European and North American markets?

There are also questions concerning the calculation and interpretation of published yields and rent series (either MSCI average or prime) in a market where turnover-based leases are present.

To cast light on this evolving situation a survey of UK valuers, agents and owners/investors was undertaken in May 2021, the results and interpretation of which constitute this part of a wider project that will consider the implications for owners and investors in determining the worth of their property assets.

Part 2 of this study, due for publication in early 2022, will investigate a number of issues, in particular:

- Is there any analysis-based divergence between price (market value) and worth?
- In assessing the worth of their properties, investors will need to estimate the future level and volatility of the cash flow from a lease with a turnover element for different proportions of base rent and turnover rent. If so, how can this be achieved?
- Worth estimates are dependent on the inputs used. Which new datasets will investors require to estimate worth?

2. BACKGROUND

Definition of Turnover-based Lease:
All or part of the rent is based on an agreed percentage of turnover or EBITDA of the lessee's business. Usually, it does not fall below a base rent.[2]

History and Use of Turnover-based Leases

Turnover-based leases[3] have been in use in many sectors of real estate, across the world, since the 1970s. In the UK, types of turnover-based leases have historically been found in petrol filling stations and public houses, although, they particularly came to the fore with introduction of retail outlet centres.

The principle of a turnover-based lease is that the rent is based on an agreed percentage of the turnover[4] of the business carried out from the property. In some cases, this may be that the whole of the rent is determined by turnover, or a favoured alternative is a fixed base rent with the overall rent being topped-up by a percentage based on turnover[5]. In all cases, the amounts agreed are negotiated between the landlord and the tenant.

Turnover-based leases can be used in all types of property where there is a measurable link between the use of the property and the ability of the tenant to pay, but their use has been most prevalent in the retail sector, particularly in continental Europe and North America.

The adoption of turnover-based leases historically has been related to the economic cycles: generally, when the market is strong, tenants prefer to pay an agreed rent without any turnover percentage, though when the market is poor and sales are lower than in previous years, a turnover rent is more likely to be preferred by a tenant[6].

The UK retail market has operated in much the same way, with some cyclical variations, since the early 1960s. In very broad terms, the UK has historically benefited from a strong landlord market with a greater demand for property than supply. This has meant that tenants have tended to agree much longer leases, at a fixed rent with upward only rent reviews. Whilst turnover-based leases have occurred in the UK previously, with the exception of outlet centres, the UK property market has primarily been one of fixed rent leases with no turnover rent element. This is in contrast to the experience of the North American and European markets where there has been a slightly different leasing tradition, one that reflected the supply and demand profiles of both the occupational and investment market in those countries.

The accompanying financing and ownership structures of the UK's property industry has been underpinned by fixed rents. In investment, a fixed, pre-determined cash flow is more valuable than a variable one. Historically, the property industry provided the finance to build new, capital intensive, retail formats and these assets were acquired by institutions and listed property companies. This equity and debt finance was underwritten by fixed rents, so a less secure cash flow could potentially push up the cost of future finance.

2 Operational Real Estate: Risk And Reward, IPF February 2021

3 In the UK, turnover rents are sometimes referred to as 'hybrid rents'. In North America, the term 'percentage rent' is used.

4 In accountancy terms, turnover is often referred to as EBITDA (Earnings before interest expenses, taxes, depreciation and amortisation) but as discussed later, the calculation of what constitutes earnings can be open to debate.

5 Turnover-based leases are should not be confused with other profit related properties such as hotels and student accommodation where the rents are a residual of the business turnover and not a percentage of the turnover itself.

6 This should also be seen against the backdrop of International Accounting Standards that now require rents to be declared as liabilities on the balance sheet. However, only 'known' rents fall under this requirement so that any turnover element is excluded; this will lead to tenants requiring more turnover-based leases for balance sheet purposes as it declares a lower liability

2. BACKGROUND

The current move toward turnover-based leases has coincided with the emergence of multi-channel retailing over the last decade, a move which has been considerably magnified by the pandemic. The impact of this shift has tipped many retailers into financial difficulties and seeking to cut rents and a reduction in the number of their stores, often via the use of the CVA process. The need for renegotiation is accentuated by the lack of movement in the business rates liability meaning that the rent is often seen as the only outflow that can be, relatively easily, reduced.

The distressed background to the move to turnover-based leases in the market has led to considerable variation in the agreed turnover percentage, the split between the turnover and the core components and the definition of turnover itself.

It is clear that the growth of internet sales has also broken the link between physical stores, footfall, turnover and profit. Rents will still be set to the correct 'economic' level but it is harder for retailers and landlords to know what that level is in a multi-channel retail environment. All markets tend towards equilibrium but when there is rapid structural change, the equilibrium shifts and rents need to find a new level. Eventually, as more transactions happen, the new level can be observed but during the transition period, comparable data is difficult to analyse. This will doubtless also affect the retail market in Europe and North America.

The move to turnover-based leases has therefore coincided with a dislocation between what is deemed an affordable rent for an occupier (commonly benchmarked by using the effort ratio) and direct turnover 'through the tills'.

It is therefore important to both determine if the current move towards turnover-based leases is a temporary or permanent reaction to the growth in online sales and the pandemic, or a longer term trend toward flexibility.

It is likely that the retail leasing model that has evolved since the 1960s is inappropriate in the new retail landscape of the 2020s, and that the entire property industry needs to adapt. Such wholesale changes require a catalyst, and the pandemic may prove the transformational event that moves the UK market to this new paradigm. As this move has coincided with a very significant fall in rents, it is crucial that this new paradigm delivers for retailers, investors and lenders if retail locations are going to attract sufficient investment to successfully adapt to this rapidly changing retailing landscape (JLL 2021).

Advantages and Disadvantages of Turnover-based Leases

From a tenant's standpoint, the advantage of a turnover rent is simple: the level of rent payable, at least in part, is directly linked to their trade from the 'physical' store. If sales are strong, the rent will be higher, but as the turnover is, by definition, also higher, then payment is more achievable. This 'alignment' between rent and turnover is bitter-sweet; with successful retailers paying more rent than less successful retailers. Satisfaction with turnover rents is therefore likely to be higher in hard economic times and for less successful retailers, than in better trading environments and for the stronger retailers.

The disadvantages are that the lease is more complex, particularly at a time when there is a desire to reduce complexity in negotiations to speed up transactions. The verification of turnover is also more management intensive for both landlord and tenant, with turnovers being certified by the tenant. The landlord has accepted in the past the certified turnover from the tenant, but with multi-channel retailing, these certifications are being questioned and/or challenged by landlords.

2. BACKGROUND

A fixed rent without any turnover element is more certain, and enforceable, for both parties. However, whilst the rent is normally at a level which is acceptable to both the landlord and tenant at the commencement of the lease, if there is a significant downturn in the market (or an adjustment to lower turnover due to online sales growth) it can cause problems of payment at that later date as the rent may be too high relative to sales at that point in time.

For the landlord, the certainty of the fixed rent in a downturn creates a more stable cash flow than a turnover rent, which will rise and fall. Turnover-based leases therefore result in a transfer of risk from the tenant to the landlord.

The Landlord and Tenant Relationship

As noted above, all market agreements will reflect the relative negotiating strength of the parties at any point in time and relative to the asset in question.

Where demand outstrips supply, landlords set the terms of the lease in their favour – this historically was a fixed rent of term certain, with regular upward only rent reviews. In such cases the landlord did not need to monitor the trading performance of individual stores as there was no turnover component to the rent collected.

Indeed, historically the rental income of the landlord was arguably divorced from that of the occupier, with the rent at rent review set to the level of new lettings in the shopping centre, high street or neighbourhood, or even by recent lettings in 'comparable' stores. This system of comparable rents relied on a standardised measure of rent. In the case of retail, this was a Zone A, which layered an extra level opacity between retailer turnover and the rent payable.

A turnover rent is at least more transparent to the retailer – and if well managed and communicated probably improves the landlord and tenant relationship. The use of a turnover component to rent also creates an incentive for the landlord to work with the tenant of their property to maximise their individual store turnover. Such a change alone may be a welcome shift from the adversarial nature of a traditional lease. This of course assumes that the landlord can influence the success of the trading asset. This may be the case for an outlet or shopping centre where the landlord can market and promote the entire centre or their brand to the financial benefit of all the tenants, but may have a limited impact when single units are involved (unless there are marketing associations set up, examples being Regent Street or Oxford Street in London).

It therefore makes sense that there should be a move towards a partnership between the landlord and the tenant, and in the case of a shopping centre, with the landlord being much more active in the management and where individual retailer performance of all units is monitored and aggregated and shared with all the occupiers of the centre.

However, the use of turnover-based leases, and therefore the provision of turnover data, does not necessarily empower a landlord to manage their property proactively. The provisions of the Landlord and Tenant Act 1954 (commonly referred to as 'the 1954 Act') restricts the ability of landlords to remove weak tenants[7]. A turnover element to rents within the 1954 Act is not sufficient alone to switch from a fairly passive to a more proactive landlord role in retailing.

Landlords may also be reluctant to allow tenants to assign (sell) their interests to another retailer on the same terms, as the value of the unit is linked to both the occupier's turnover and any terms specific to them and not that of a potential new tenant.

[7] In December 2020, the Government announced a formal review of the Landlord & Tenant Act 1954 in 2021. This is currently at the consultation stage and the research is undertaken against the backdrop of the existing legislation as of July 2021.

2. BACKGROUND

Current Market Conditions and Prevalence of Turnover-based Leases by Sector

The catalytic impact of the pandemic is that current market conditions appear to favour the use of turnover-based leases.

The question is whether this is should be seen more as a structural change in the market or a cyclical adjustment. The answer to that question may vary according to the type of asset. For example, it is more likely to be a structural shift in shopping centres and some retail parks[8] as the landlords have already been active in promoting these for the benefit of all their tenants and may have aggregated turnover figures for the centres. This is in contrast to the high street, where ownership is much more fragmented and aggregated shared information is less likely to be available. As such, the environment needed for the continuation of turnover-based leases over the longer term may simply not be present (Hutton and Rhodes, 2021).

Range of Terms and Agreements

A wide range of turnover agreements has been noted in the UK. These may be:

a. A pure turnover arrangement where all of the rent is based on a percentage of turnover
b. A split between a base rent plus a turnover uplift; or
c. A ratchet mechanism that reviews the rent to the higher of the base rent or a given percentage of the turnover.

Within the specific arrangements above, there can be a range of splits between the base rent and turnover rent; growth; ratchet clauses and stepped base rents. As such, the permutations of turnover-based leases are quite numerous.

The key terms in any turnover-based lease are:

a. base rent – the fixed amount of rent that is paid;
b. turnover – the turnover of the tenant, subject to definition;
c. turnover threshold – the amount of turnover at which a turnover rent becomes payable;
d. turnover rent % – the percentage of turnover for which a turnover rent is payable;
e. duration of any turnover rent, and;
f. whether the rent is inclusive or exclusive of service charge and/or rates and other expenses such as marketing.

There does not appear to be any commonality in turnover-based lease terms. It is strange when there are existing turnover agreements available in outlet centres and also in Europe that the UK has failed to adopt these standardised agreements and have, instead, reinvented the wheel each time.

It is possible that standard lease types will develop and indeed, the Model Commercial Lease (2021)[9] does offer model leases for retail units with turnover rents. Generally, market norms and conventions will lead to standardisation but the immediacy of the pandemic has meant that such an evolution has not happened yet.

8 Turnover-based leases do not seem to be prevalent for supermarkets where long leases on fixed rents with agreed uplifts are more the norm. Also, as supermarkets did not suffer during the pandemic (albeit their business models did move towards more home deliveries) as the pressure that led to the increase in turnover-based leases in other sectors did not apply.

9 The Model Commercial Lease (2021), a free website, originally commissioned by the British Property Federation (BPF), does offer model leases for retail units with turnover rents.

2. BACKGROUND

One of the areas of interpretation is between the interaction of physical stores and online shopping.

- Sales may be initiated online through Click and Collect, with stores offering different options to the consumer at the point of purchase.
- Some require payment to be made online, with the collection at the store not constituting a sale towards the store's turnover.
- Others reserve the item in store for payment at the point of collection, which counts towards store turnover.
- Some use the shop as purely as a showroom to generate sales online, with no sales being attributed to the physical store.
- Conversely, sales made online but returned to a physical store may be subtracted from the store's turnover as the refund is processed through the tills.
- A sale may be made in store but fulfilled direct to the customer from a central warehouse.

How these additional items are considered will depend upon whether you are a landlord or tenant but collectively these additional incomes (or expenses) are known as 'halo' incomes (Harper (2021).

As the market evolves, it is therefore imperative to have some standardisation to help the logistics of collecting and sharing data, which underpins the agreements and models for valuation and worth analysis.

Risk, Volatility and Specific Risk

One of the issues that needs to be considered is the change in the risk profile of the cash flows between turnover-based leases versus fixed rents. This has an impact on the valuation of the property (see Chapter 2 – Valuation) as well as worth.

Covenant strength risk

- With any letting there is a risk that the tenant will be unable to fulfil the terms of the lease. In the case of a fixed rent lease, the tenant covenant strength is related to the volatility of the retailer's total turnover (all retailers are generally less likely to be able to pay their rent in a cyclical downturn, although it is the weaker retailers that are likely to actually default – notable examples being Woolworths, BHS, Arcadia Group etc.)
- In theory, covenant strength would be enhanced with the use of turnover-based leases, where the base rent is set at a level that allows for expected reductions in turnover. However, for weaker retailers, unless the base rent component is set very low, the retailer is still likely to struggle due to their other overheads. Turnover-based leases therefore do little to directly reduce covenant risk in practice.
- However, the inclusion of turnover-based lease breaks, where the landlord can evict tenants that are not performing at agreed levels of turnover and replace them with tenants who are likely to perform better, would potentially allow the landlord to 'weed out' weaker retailers before an economic downturn[10]. The concession of a turnover element in return for a turnover-based lease break[11] may therefore lead to a lower covenant risk. Further, if weaker retailers are removed before an economic downturn the landlord is less exposed to multiple failures.

[10] However, a cost barrier to this proactive management, has been the recouping of incentives paid for fit outs at the lease's start, although, there is a move toward fewer individual fit outs for sustainability reasons.

[11] A break in the lease that can be exercised by the landlord if the tenant is not able to achieve a target turnover over a given period of time.

2. BACKGROUND

Volatility of rent – positive and negative growth

- With a fixed rent lease, the cash flow is protected from the volatility of retailer turnover. A fall in retailer turnover may impact the ability of the tenant to pay, and also, pay on time (see covenant risk), but the amount payable remains constant as agreed in the lease.
- Further, with fixed rent leases the rent is set with reference to market rents which are less volatile than the turnover of individual stores. So, with turnover-based leases, the lower the base rent the more income will flex with individual store turnover, creating a more volatile cash flow. In theory, the landlord should be compensated with a higher overall rental income (fixed plus turnover component) for this additional volatility. However, the legitimacy of a landlord's claim to such a higher rent is likely to be strongly resisted and their ability to extract such a premium in negotiations questionable.
- The higher volatility of turnover rents works both ways. With a fixed rent, rents historically have only been reviewed periodically. If rents rise over time, the rent payable will lag current rental levels, leading to lower aggregate rental payments by retailers. If rental values fall over time, the reverse is true and rents will often be 'over-rented'. In an era of rising online sales, fixed rents favour the landlord during ownership.
- The attractiveness of a turnover rent to the landlord can be significantly enhanced if the base rent is increased annually in line with inflation. With fixed rents, uplifts occurred only every five years; this is less attractive to the investor than an annual uplift. Whether inflation outstrips retail rents is an arguable point, but for investors with inflation linked liabilities, annual inflation uplifts are attractive for liability matching, especially if accompanied by a ratchet clause[12].

Growth

- Arguably the rent setting mechanism should have no bearing on the total level of rent payable, it merely re-apportions the risk and adjusts the rent appropriately. However, it is possible that the leasing structures could affect the vibrancy of the environment. If asset managers have more data on turnover and are able to adjust the tenant mix proactively, then the overall rental tone may be higher. Further, if this rent setting mechanism favours weaker incumbents, thereby preventing leaner or newer retailers from entering the location, the location as a whole may then suffer as a consequence. In the era of online sales, such innovation may be essential to enable a revival of the high street.

Specific risk/stock selection

- With fixed rent leases, rents are set by demand and supply for similar retail space in the vicinity, not by the trading of the specific unit or retailer. The investor return will therefore be determined by the location as a whole, not just the individual store that is owned.
- With turnover-based leases, the investor return is linked more directly to the individual store/retailer. This increases the importance of stock and occupier selection on investor returns and increases specific risk.
- In theory, specific risk can be diversified. However, stock and occupier selection will be of increased importance (requiring more research and enhanced data).

Transparency

- As a general rule, reduced transparency for investors increases the risk premium required and thus reduces value. A move towards turnover-based leases, with greater transparency and more shared data, may lead to a decrease in the required risk premium. Whilst this may be appear to be counter-intuitive, it means that a move towards more turnover leases, from the investor's viewpoint, can have a positive impact upon the worth of the asset and on its capital value.

[12] A ratchet clause prevents rent from going down after a rent review has been conducted.

2. BACKGROUND

Data Requirements and Investor Involvement

Generally, there is not enough data on the terms of turnover-based leases. Either confidentiality clauses are restricting the information flows, data is not being correctly collected, or the data is not being collected in the first place.

Where turnover data is being used (well), it is usually where the landlord controls multiple units in the same centre/location and thus the data can be aggregated and shared with all the tenants on a confidential basis for the benefit of both the landlord and tenant, as well as the valuer, who has to assess market price based on these cash flows.

However, not all cash flows can be captured. Halo incomes are difficult to consistently define, quantify and determine. It may be that the 'worth' of these halo incomes might be captured in the base rent, with the turnover rent only capturing sales through the physical store.

Research Questions

The history of turnover-based leases in retail suggests that it is a concept that can be adopted and used across property sectors, though there are questions that need to be asked to understand the increase in their use, and drivers thereof, in the current market. Specifically, the research needs to determine:

- The extent of the use of turnover-based leases by property sector;
- The variation in terms and agreements relating to turnover-based leases;
- The range of base rents as a proportion to turnover rents;
- Whether this is likely to be a temporary change of or a structural shift in the market; and
- Whether a move towards turnover-based leases will lead to:
    i. Higher incomes overall;
    ii. Higher volatility and risk; and/or
    iii. Stronger covenants.

The questionnaire was designed and targeted at a specific universe of respondents to try to understand the current market trends and drivers relating to turnover-based leases.

3. VALUATION OF TURNOVER-BASED LEASES

The majority of the readers of this research will be familiar with property valuation and modelling. To avoid any misunderstanding or varying interpretations, Appendix A clarifies valuation definitions and the use of different valuation approaches, methods and models (see Gabrielli and French 2021).

3.1 Treatment of Turnover Components.

One of the requirements of any property valuation is to capture the risk profile of the cash flows pertaining to the asset being valued. As market rents are determined by comparison, it is imperative that the valuer reflect the correct risk profile of each type of rental agreement. These are different for leases with fixed rents and those with a turnover element, and the risks manifest themselves in different ways (see Chapter 1, Risk, Volatility and Specific Risk). If a property's rent has a turnover element within it (in any of the forms described in Section 1), future cash flows will be volatile as they move with the economy or in line with structural changes (e.g. the transition to online retailing). Hence, the turnover element introduces greater risk into the performance of the asset.

The question is, therefore, whether (or how) this tranche of the cash flow, which has a different risk profile, will be treated by the valuer within the chosen valuation model. In an implicit model, the base rent is treated as a more secure cash flow, and therefore valued at a market ARY, whereas the turnover element will be valued at a higher rate to reflect the addition risk of this element of the cash flow. This could also be a technique in the explicit DCF model, albeit with the cash flow being projected beyond the current rental income.

3.2 Establishment of Market Rent

Valuers estimate the appropriate Market Rent for the subject property by means of comparison. This is relatively straightforward where the rent does not include a turnover element, as the Market Rent on a comparable property can be easily observed.

However, as soon as a turnover element is introduced, the determination of the Market Rent becomes much more difficult. We now have comparable properties where there is a base rent and a potential turnover top-up depending upon trading conditions. Yet, the turnover element is generally only known between landlord and tenant, so it cannot be (correctly) integrated into an equivalent Market Rent figure. Even if the turnover element is known to the valuer, there is no standardised model of calculating this equivalent Market Rent.

There should be a standard calculation that equates the base rent with any turnover rent to a Market Rent in order to provide a basis for consistency to assess the appropriate rent to value. Part of the problem is that there are two growth rates in play when there is a turnover element with a base rent. Many base rent agreements are tied to the higher of indexation growth or Market Rent, whereas the growth in turnover rent can be either positive or negative depending upon the trading performance of the occupier. This can be difficult to model. In such event, the minimum expected turnover rent is usually modelled but how is that then analysed to incorporate it into a Market Rent figure?

The crux of the valuation, where the implicit model is used, is the determination of the Market Rent and the appropriate ARY. The UK capitalisation model refers to a headline Market Rent rather than a base rent plus a turnover rent. The implicit model does not adapt easily to different valuation inputs and this reinforces the need for a standardised method of analysing the mix of base rent and turnover rent into one overall headline rent.

3. VALUATION OF TURNOVER-BASED LEASES

The other issue relating to retail is that, historically in the UK, retail units have been let on rents based on Zone A rentals through arithmetic zoning. This is a valuation model that determines the rent payable with reference to the length of the retail frontage and depth of the shop. The model works on the basis that the first specified depth of the shop is the most valuable and should be valued at a Zone A rate. The next zone is considered to be half as valuable and the next half again. In the UK, the most frequently used depth is 20 ft but conventions adopted in different regions have led to the use of 15 ft or 30 ft zones or their metric equivalents. The important issue was to analyse and value on the same zone basis.

On this basis, the rent of the shop can be expressed in terms of zone A (ITZA) and it ensures that a wide shop with a larger frontage (to attract the consumer to enter the shop) has a higher rental value than a narrower unit with greater depth, even if the overall area of each shop is the same. The impact of a greater share of online sales and the use of turnover-based leases is therefore likely to reduce the relevance of this valuation convention.

For both the implicit and explicit valuation model where a Market Rent is required as part of the valuation, issues can arise in the calculation. It might be possible to value the base rent and the likely turnover rent separately within an implicit model though, in so doing, the valuer is relying more on complicating a model which relies upon simplicity to assess value. It may be better practice to use the explicit model where the two elements of the overall rent can be separated in the cash flow so their respective growth potential can be applied correctly.

3.3 Research Questions

To ascertain how valuers are adapting their valuation models to capture the impact of turnover rents on capital values, the research sought to determine:

- What valuation approaches, methods and models are being used;
- How valuers are determining an overall Market Rent that captures the turnover element in the market;
- What the appropriate ARY or equivalent yield is and whether valuers use different yields on the turnover element. If so, what is that yield differential?
- Whether current valuation software is sufficiently adaptable to model turnover rents or whether there is a need for the use of internal/Excel workarounds;
- What data is currently available and used. Are there any lacunae relating to:
    a. Valuation data and comparable evidence?
    b. Turnover data for the specific tenant provided by the investor?
    c. Aggregated turnover of comparable tenants in the same location/asset?
- Given the above, what gaps do valuers consider there are in current provision and are those gaps being sufficiently plugged by internal and external datasets?
- Lastly, are the valuation models in use sufficiently transparent to allow their analysis to provide useful comparable market data?

In order to address these questions, responses were sought to a survey designed and targeted at a specific range of respondents to identify and understand current market trends and drivers relating to turnover rents.

4. SURVEY FINDINGS

To identify current trends in the use of turnover rents, the approaches, methods and models taken to their valuation and the comparable evidence and datasets available to valuers, a survey was undertaken in May 2021 of the UK's largest property valuation houses, leading retail agents and largest investors, principally in the UK (with some additional responses from US and Continental European counterparts within the valuation houses).

While the survey was aimed at the higher value, 'institutional' end of the market and, thus, representative of the greater part of the UK property market by value, is not reflective of the lower value 'tail' of properties in smaller (but not necessarily weaker) locations. However, responses from valuers dealing with a wide range of property assets did provide insights and indicative comments about the market as a whole. The survey results were used to identify the implications for accessing and analysing comparable evidence and for published market rental growth and yield series that are based on valuation data.

4.1 Survey Results

Asked about the extent of the use of turnover rents by sector, survey responses made it clear that the increased use of turnover-based leases was, in the main, restricted to the retail sector. Analysis has been concentrated, therefore, on the results for the high street, retail parks, shopping centres, leisure and restaurants/F&B.

4.1.1 List of terms

The terms SBR (Sales Based Rent), TOR (Turnover Only Rent) and TOT (Turnover Top-Up) and TOC (Total Occupational Cost) were identified by respondents as widely used in the market, as noted in Table 3.1.

Table 4.1: Turnover-based Leases – List of Terms

	Turnover Lease Types	Variations	Terminology
1	Turnover only	Single turnover percentage rate, or banded incremental/ decremental	Pure TOR or SBR (sales-based rent)
2	Base and turnover top-up	Stepped turnover percentage rates (rising in specified years)	Mixed TOR
3	Base rent and turnover top-up with annual reviews of base rent dependent on previous year's turnover performance	Base rent ratchet can be to higher of CPI inflation or 80/90% of last year's total rent	Ratchet TOT or Base with ratchet and turnover top-up or Ratcheted base rent
4	Total Occupational Cost – inclusive of service charge –this can be on a base rent or turnover		All-in TOR or TOC
5	Indexed leases reviewed annually and may include turnover element		
6	Profit and loss		

4. SURVEY FINDINGS

4.1.2 Proportion of leases on turnover rents

Surveyed owners were asked to supply a breakdown of the number of retail and leisure leases that had a turnover component. The proportion of all leases with a turnover component was 7.7% overall, rising to 14.4% in shopping centres.

Table 4.2: Turnover-based Leases – Proportion of All Leases

	Number of leases	Proportion including a turnover element
High Street Retail	626	2.7%
Single Occupancy Out of Town Unit	36	0.0%
Retail Parks	874	1.1%
Shopping Centres	1,387	14.4%
Leisure	225	6.7%
All Retail & Leisure	**3,148**	**7.7%**

4.1.3 Are turnover rents considered to be standard lease terms?

All valuer respondents believed turnover rents were now standard lease terms in shopping centres, whilst over half of respondents believed this to be the case in leisure, restaurants/F&B and high street retail. For retail parks, several respondents expressed the view that turnover rents were concessions, in order to let vacant units or were a response to a restructuring (including CVA), rather than standard lease terms. The small sample of owners and agents were also unanimous that turnover rents are standard lease terms for shopping centres with the majority responding that this is also the case in other types of retail.

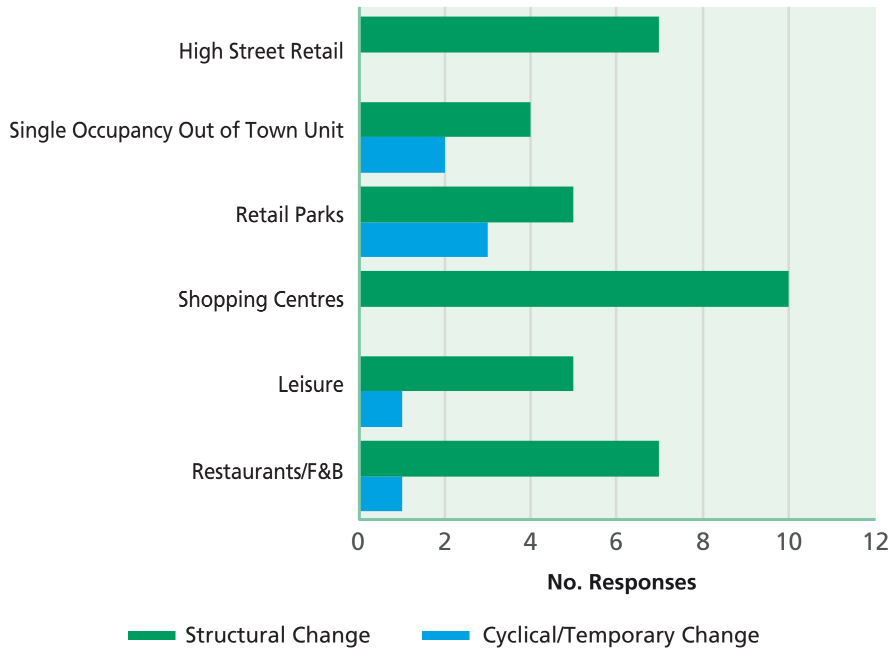
4.1.4 Temporary or structural shift?

All valuer respondents believed the change was structural for shopping centres and high street retail and a majority that it is structural for leisure and restaurants/F&B. Valuers were more evenly split between a cyclical and structural change for single occupancy out-of-town and retail parks. Valuer responses are summarised in Figure 4.1.

The owners and agents were also unanimous in describing turnover rents as a structural shift for shopping centres, high street retail leisure and restaurants/F&B; a minority responded that it is only a temporary shift for retail parks and single occupancy out-of-town.

4. SURVEY FINDINGS

Figure 4.1: Temporary versus Structural Shift (Valuers)



4.2 Do Turnover Rents Lead to Higher Income?

The responses from valuers were split, with six of the 11 believing turnover rents led to higher income over the long-term. However, additional comments suggested turnover-based leases were not designed to generate a higher income per se but that they would lead to more proactive management of the assets concerned and deliver higher income as a result. Many respondents referenced the use of turnover rents to lower the current rent to an affordable level and the need for turnover to capture some of the growth from online sales.

The owner respondents all answered that turnover rents led to higher income.

4.2.1 Do turnover rents lead to higher volatility?

The valuer respondents were split equally as to whether turnover rents led to a higher or lower volatility of income, albeit this may have been due to differing interpretations of the question. Existing fixed rent cash flows have been extremely volatile as a result of CVAs and bankruptcies leading to substantially lower or no income. Hence, any rental agreement entered into following such an event is likely to be less volatile. By contrast, comparing a turnover rent to a fixed rent going forward, as the turnover element is, by its nature, undetermined, the cash flow would be more volatile.

Owner respondents were almost unanimous that turnover rents led to higher volatility of income.

4. SURVEY FINDINGS

4.2.2 Do turnover rents lead to a stronger covenant?

Valuer respondents were also divided almost equally as to whether or not turnover rents led to a stronger tenant covenant. The positive view was split again, between the increased likelihood that the tenant could withstand an economic downturn if their rents could flex lower and the ability of landlords to asset manage tenants, ideally outside the 1954 Act, to avoid future problems. Many respondents stated that the lease had no impact on covenant strength.

All owner respondents subscribed to the view that the ability of rent to fall in a downswing increased.

The interviews afforded the chance to ask the respondents to clarify their earlier answers to the survey questionnaire; detailed responses appear in Appendix B.

4.3 Use of Valuation Models

Asked which valuation approach they applied in each of the retail markets, all valuers chose to use the Investment Method but within that method there was the further choice of which valuation model to use. The implicit model was used throughout all retail and, for shopping centres, all used both the implicit (principally) and explicit model (as a cross-check to the implicit model). In the other property sectors, at least half of the valuers also used the growth explicit model. Valuer responses are shown in Table 4.3.

Table 4.3: Frequency of Use of Valuation Models

Retail Type/(No. Respondents)	Implicit Model	Growth Explicit Model (DCF)
High Street Retail (7)	7	4
Single Occupancy Out of Town Unit (8)	8	4
Retail Parks (9)	9	5
Shopping Centres (11)	11	9
Leisure (7)	7	4
Restaurants/F&B (6)	6	4

Most valuers indicated they used the explicit DCF model to value turnover rents but, during the interviews, it was determined that the implicit model was the dominant valuation model in the UK and, where DCF models were used, their purpose was to check the market value determined by the implicit model, by calculating the IRR based on that price. This was also done to help 'mirror' what their clients might be doing, particularly if overseas-based.

4. SURVEY FINDINGS

4.4 What is the Market Rent?

Asked to define both the Headline and Net Effective Market Rent, several respondents included the turnover component in the Headline Market Rent and were frank about the difficulty of estimating Market Rent and Net Effective Market Rent in the current market.

4.4.1 When do you revert to Market Value in the valuation?

Respondents were asked at what point in their valuation model (implicit or explicit) they revert to a capitalisation of the rent into perpetuity. This could be at the rent review, the next break, the lease end, a pre-determined holding period, other or mixed. There seemed to be a mixed pattern of responses with most valuers indicating that it is either to the net-effective rental value at the next rent review or to headline rental value at next break or lease end.

4.5 Distinguishing Base and Turnover Elements of Rent

All respondents separated out the turnover income from the base rent in the cash flow to be valued.

4.5.1 What yield do you use on the turnover element in the valuation?

Eight of the valuers applied a different yield to the turnover rent to that applied to the base rent with two using the same yield, although the situation is not always clear cut. That said, it was noted that in today's market, where the turnover element is likely to be minimal at best, the change in yield will have little impact on the valuation. The respondents reported that the implicit valuation model was applied when a small turnover element was common, as it was felt that this was included in the comparable evidence.

4.5.2 Do you assume growth in the turnover element in the valuation for the Implicit Valuation model?

Using the Implicit valuation method, valuers were split down-the-middle between whether or not some growth is assumed in the turnover for Retail Parks, Leisure and Restaurants/F&B.

4. SURVEY FINDINGS

Figure 4.2: Assumed Growth in Turnover

4.5.3 Do you assume growth in the turnover element in the valuation for the Explicit Valuation model?

For the explicit valuation method, the majority of respondents assumed growth in the turnover element. Often CPI has been assumed but one respondent referred to an internal forecast. Several respondents referred to property level adjustments where the valuer made specific assumptions for each unit before aggregating the valuation. In other words, the valuer is looking at the prospects for each occupier and making different adjustments accordingly.

4.5.4 Do you value turnover-based leases by DCF?

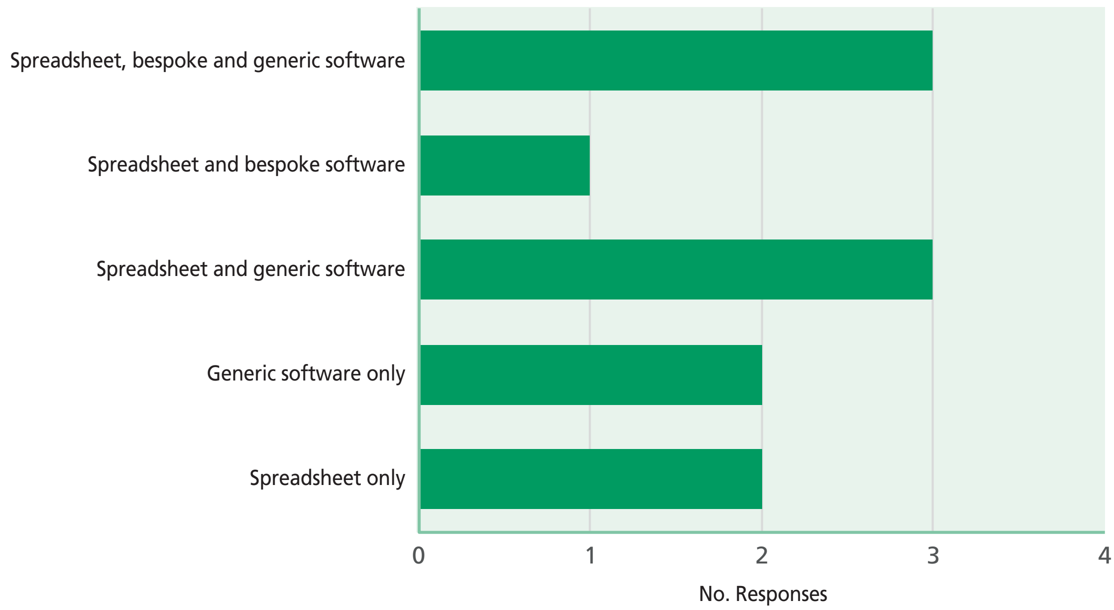
Seven of the valuer respondents indicated they used an explicit DCF model to value a property with turnover rents, three solely used the Implicit valuation method, whilst one used both. Those respondents using an explicit DCF indicated this approach was taken only for shopping centres/complex assets. Several stated that an explicit DCF was used for checking the IRR based on the implicit valuation, and not to calculate Market Value itself (a ‘sense check’).

4. SURVEY FINDINGS

4.6 Valuation Software

Respondents were asked about the software used to undertake the valuation of turnover rents. Nine valuer respondents used in-house spreadsheets to value turnover-based leases, with six of these using a combination of spreadsheets and valuation software, of whom, four used bespoke software. Two valuers indicated sole use of generic valuation software. A summary of responses is shown in Figure 4.3.

Figure 4.3: Valuation Software Use



4.6.1 Adaptability of Software

Many respondents noted that their valuation software, where used, did not adapt well to turnover modelling. Several had had software adapted for turnover-based leases, others switched to Excel either for transparency in calculation or due to perceived limitations in their valuation software.

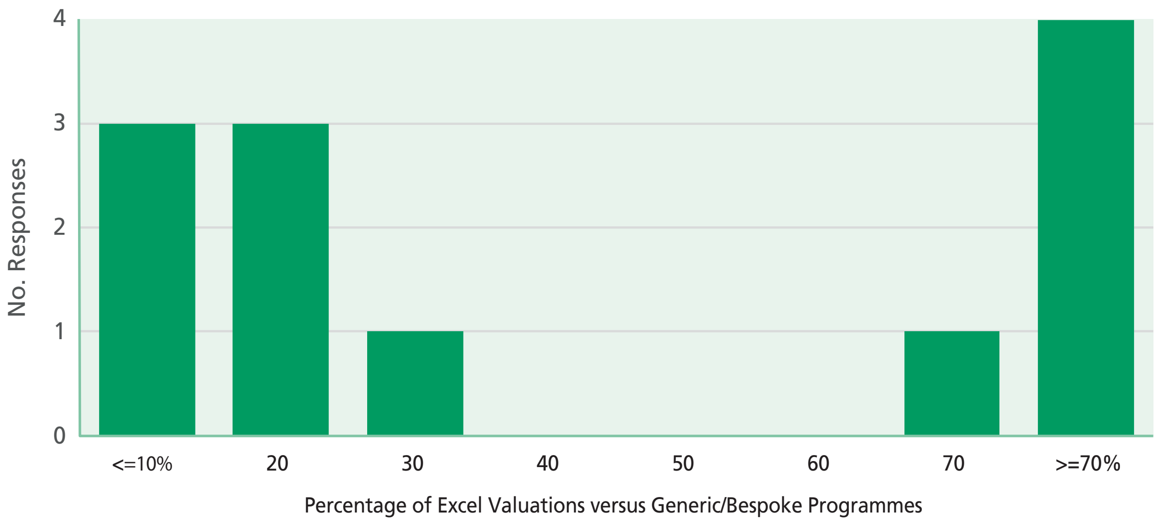
Half of the valuer respondents are in the process of building new Excel templates and/or asking their software provider to build modifications to allow for the valuation of turnover rents. Respondents were split as to whether it was preferable to enhance industry software or build Excel templates.

4.6.2 Proportion of Valuations Undertaken by Software Type

The valuer respondents were split between undertaking the valuation of virtually all (>70%) rents in Excel or only a small proportion (30% or less). Some valuers reported modelling in Excel and exporting into valuation software and some reported modelling in valuation software and exporting to Excel.

4. SURVEY FINDINGS

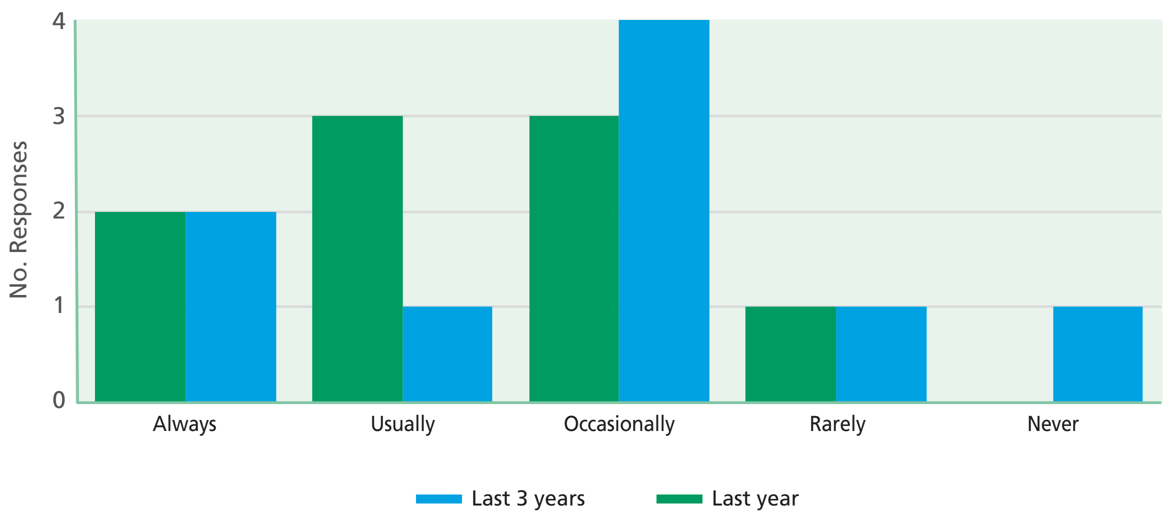
4.4: Valuation Modelling Usage



4.7 Turnover Data

Valuers were asked how often turnover data was provided for turnover rents on lease renewals. The responses were split, with half responding that data for the last year was provided always or usually and half occasionally or rarely (see Figure 4.5). Valuer responses were echoed by those of both owners and agents.

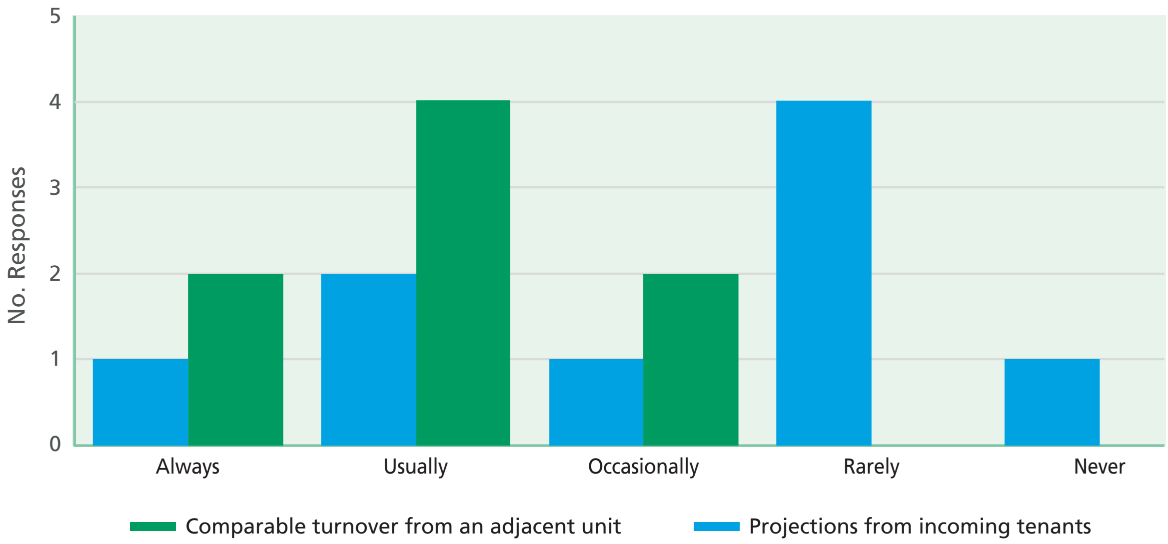
Figure 4.5: Provision of Turnover Data – Lease Renewals



4. SURVEY FINDINGS

A similar question was also asked for new leases, with respondents asked if data was provided for adjacent units or projections were provided by the incoming tenant. Again, the responses were split with half reporting that comparable data from adjacent units was rarely or never provided, but three advised it was either always or usually provided. Projections from incoming tenants were usually or always received by seven respondents and occasionally by two (see Figure 4.6). Again, the valuer responses were echoed both by those of the owners and agents.

Figure 4.6: Provision of Turnover Data – New Leases



4.7.1 Impact of Data Restrictions on Valuation Model

Overall, nine of eleven valuer respondents considered their choice of valuation model was restricted by a lack of data.

4.7.2 Availability of Market Data for Implicit and Explicit Valuation

Respondents were asked whether comparable rent and pricing data was missing for both the implicit and growth explicit valuation models. For valuers using either valuation model, comparable rent data (see Table 4.4) was reported to be missing either occasionally or more often always by all respondents in all segments bar shopping centres.

4. SURVEY FINDINGS

Table 4.4: Missing Rent Information

	Implicit Model			Growth Explicit Model (DCF)		
	Always	Occasionally	Never	Always	Occasionally	Never
High Street Retail	3	3	0	3	2	0
Single Occupancy Out of Town Unit	5	1	0	5	0	0
Retail Parks	4	2	0	4	1	0
Shopping Centres	5	1	1	5	0	1
Leisure	3	2	0	3	1	0
Restaurants/F&B	2	3	0	2	2	0

Apart from one respondent, the comparable pricing data (yield information – Table 4.5) was reported as missing either always or occasionally for the implicit valuation model.

Table 4.5: Missing Price (Yield) Information

	Implicit Model			Growth Explicit Model (DCF)		
	Always	Occasionally	Never	Always	Occasionally	Never
High Street Retail	4	2	0	2	2	1
Single Occupancy Out of Town Unit	6	0	0	4	0	1
Retail Parks	5	1	0	4	1	0
Shopping Centres	6	1	0	4	1	1
Leisure	3	2	0	3	1	0
Restaurants/F&B	2	3	0	2	2	0

4. SURVEY FINDINGS

The consensus opinion in the follow-up interviews was that there is sufficient comparable rental information for fixed rents.

4.7.3 Data Shortcomings

Respondents were also asked whether turnover trends, for either the current occupier or occupiers more generally, were missing for both valuation models. For the current occupier, valuers were split, with some reporting that data was always missing, some occasionally missing but some that it was always reported.

Table 4.6: Missing Current Occupier Turnover Information

	Implicit			Explicit		
	Always	Occasionally	Never	Always	Occasionally	Never
High Street Retail	0	6	0	0	4	0
Single Occupancy Out of Town Unit	1	3	1	1	2	0
Retail Parks	1	2	2	1	1	1
Shopping Centres	1	6	0	1	4	0
Leisure	1	2	1	1	1	1
Restaurants/F&B	0	3	1	0	2	1

4. SURVEY FINDINGS

For valuers using either valuation model, turnover trends for occupiers generally was reported to be missing only occasionally but one respondent considered such data as always missing.

Table 4.7: Missing General Occupier Turnover Information

	Implicit			Explicit		
	Always	Occasionally	Never	Always	Occasionally	Never
High Street Retail	0	5	0	0	4	0
Single Occupancy Out of Town Unit	1	3	1	1	2	1
Retail Parks	1	3	1	1	2	1
Shopping Centres	1	5	0	1	4	0
Leisure	1	3	0	1	2	0
Restaurants/F&B	0	4	0	0	3	0

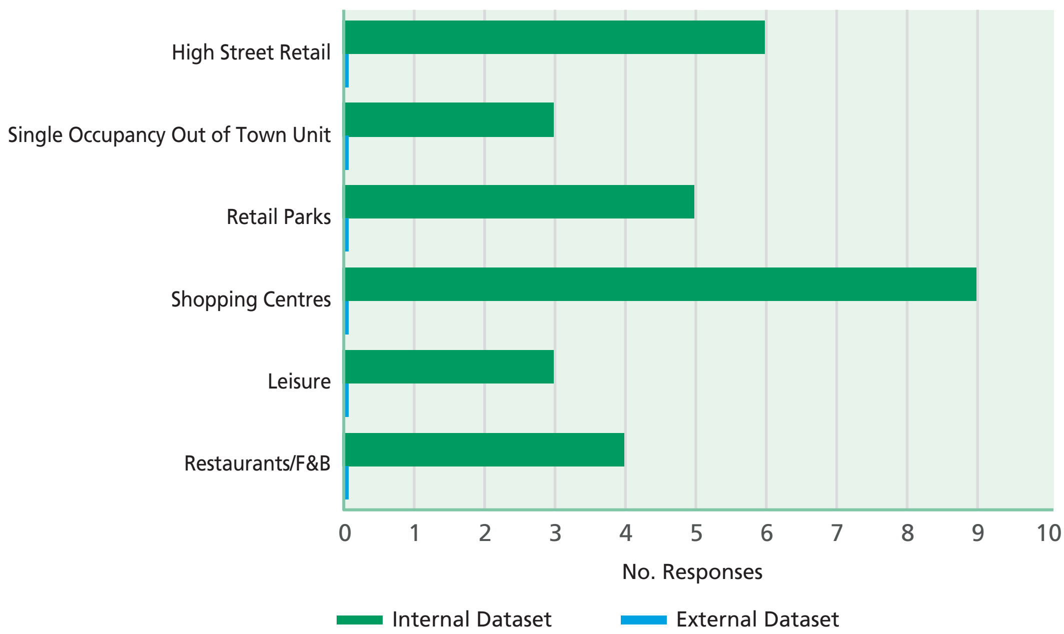
Most surprising was the regular comment from the valuers that clients did not automatically pass on turnover information from the properties where there was a turnover element within the rent. Part of this was due to clients believing that the passing of the data to the valuer would be outside the terms of the non-disclosure agreements (NDAs) with their tenants, but the end result is that the valuer is being asked to value a cash flow without any information of its magnitude. It would be useful and helpful if market practices evolved so that there were no impediments to information flows between retailer and investor, and then the investor and valuer.

4. SURVEY FINDINGS

4.7.4 Sourcing Data

Many respondents were developing internal datasets to support their valuations. But all respondents noted that there were none or no reliable external databases available for turnover rents (see Figure 4.7). It was only in the hotel sector where a respondent reported subscribing to an external dataset (not shown here).

Figure 4.8: External versus Internal Datasets



5. KEY FINDINGS AND CONCLUSIONS

The survey and interviews highlighted a number of themes and issues that resonated with the participants. There was a great degree of consensus on the issues facing retail, though less agreement on the likely outcome of the current change and the timeframe for this.

Everyone agreed that the speed of change in retail has meant that the retail market is going through a structural change, and that for some retail categories, primarily larger shopping centres and existing outlet centres, the use of turnover rents will increase and become standard in lease agreements.

5.1 Further Striation of Retail Market

Initially, there was discussion about the different issues affecting shopping centres, retail parks and the high street. However, as the research progressed, it became clear that the solutions that may work for a large regional shopping centre would not be appropriate for a smaller town centre scheme.

There are three drivers impacting the increased use of turnover rents;

- the occupier's demand for such a contract,
- the use of the CVA process that imposes them, and;
- landlords choosing to move towards such agreements to better manage their investments.

Thus, some property assets will lend themselves to an increased and enhanced use of turnover-based leases, and some will retain a fixed rent lease structure. Likewise, some retailers, most notably in fashion, are likely to ask for them in their leases where there is a likelihood of a more favourable rent being paid, regardless of market conditions. Whereas the CVAs hopefully will gradually fade from the market as trade and affordability return to some form of equilibrium.

One of the central themes noted by all respondents to the survey was the difference between the motivation for moving towards a turnover-based lease. In many cases, there was a genuine desire to develop more of a partnership between landlord and tenant, and an expectation that the retailer would experience turnover growth that will flow through to an additional income flow for the landlord based on a base rent plus turnover rent agreement. However, it was also noted that many turnover-based agreements were predicated on the current fixed rent being unaffordable and the parties agreeing to a lower base rent plus turnover rent lease where there was no real expectation of turnover increasing sufficient to trigger the turnover rent component. In these cases, the use of a turnover-based lease is just a mechanism to rebase the fixed rent payable to a lower level and it is likely that the reference to the turnover component will be removed once the market has adjusted rents to match the affordability of the rent by the tenant.

It is clear that the retail market is going through a period of transition and that this is both being driven by the impact of covid in terms of an accelerated move towards online shopping but also being hindered by the impact of lockdowns. As a result, the adjustment to an equilibrium between supply and demand is likely to be disrupted by short-term changes in in-store consumer spending that coincides with the ending of lockdowns and the impact of pent-up demand in the UK economy.

5. KEY FINDINGS AND CONCLUSIONS

Table 5.1: Use of Turnover-based Rents by Retailer Type

	Fixed Rent Leases	Turnover-based Leases	
Retailer category		Rebasing of Market Rent or CVA provision	Genuine Share of Turnover
Fashion	Many fixed rents too high relative to current market; tenants renegotiating either lower fixed rents or moving to base plus turnover	Leases often renegotiated directly with landlord or imposed at 100% turnover by CVAs, as original agreed rent too high relative to effort ratio	Many fashion retailers choosing to move to turnover-based leases for all, or most, of portfolio; appears to be mix of market change and advantage in accounting treatment, as only fixed rents recorded as liability on balance sheet
F&B	Smaller F&B willing to sign shorter leases on fixed rents but inclined to move to turnover-based lease on expansion/ increased success		F&B outlets motivated to sign longer leases (to allow depreciation of fit out costs) on turnover-basis, provided base is reasonable and turnover percentage appropriate for effort ratio
Discount	Generally no wish to sign turnover-based leases; prefer to agree fixed rents		
Electrical	‘Showroom’ electrical/ mobile/computer occupier has no wish to share turnover information, as often sees space as a way to increase online sales, so fixed rents preferred		
Homeware			Other homeware tenants may seek turnover-based leases in short-term to allow rebasing of market rent
Department		Department stores no longer benefit from preferential terms as anchor tenants; many remaining stores moved to 100% turnover following CVAs	

5. KEY FINDINGS AND CONCLUSIONS

5.2 Use of Turnover Rents

First and foremost, turnover rents in the UK retail sector have been a means of reducing rent during an economic 'perfect storm', and may not continue when the market stabilises. Their use has been like 'catching a falling knife in the dark', as many factors are driving the market at present and their interaction is not linear. The main factors identified were:

- Increase in internet sales;
- Pandemic-induced closures mandated by Governments;
- Side agreements for tenants to remain in occupation;
- Use of CVAs as a precursor to bankruptcy;
- Demise of department stores;
- High occupancy costs in UK; and
- The need for individual, non-UK, agreements to attract international brands who wouldn't sign standard tenancy agreements.

The other issue is where turnover rents have been introduced, there is no standard agreement. There are turnover rents, and then there are turnover rents (whole scheme, real time data, outside the 1954 Act with turnover-related lease breaks). This means that some turnover rents are 'true' agreements where there is a possibility and likelihood of additional rent above the base rent, whereas other agreements are called turnover-based leases but that has not been the intention of the agreement (as the turnover is unlikely to increase, the base rent is actually a fixed rent by another name).

Even with true turnover agreements, are turnover-based leases a 'superior' leasing solution i.e. leading to higher growth, less volatility, improved covenants and lower costs? This may only be true within certain parameters:

- Retailers are willing to pay a higher rent for the reduced risk of a turnover lease and flexibility. This is similar to serviced offices, where tenants pay a higher rent for flexibility.
- Benefit for management/change in rents by using turnover data
- Access to turnover data arguably gives landlords the information to manage destinations (where they control the precinct) more effectively, e.g. trading off car park charges with higher turnover income
- Landlords can only use this new information if combined with leasing outside The Act with turnover-related lease breaks.
- Retailers and landlords alike value access to comparable turnover data, as they can determine their trading performance relative to their peers
- It is possible that aggregate retail sales/rent of the entire retail precinct may be greater if rents are allowed to vary by occupier type, which is generally not how rents have been set in the past; outlet centres may be evidence of this strategy.
- Retail leases may become more 'turn-key' solutions – essential to avoid waste of re-fitting space between occupiers. Retailers may prefer ask for gross leases on space that has already been fitted-out, thereby paying for the flexibility of not requiring, or depreciating, the cost of fit-out.

Such solutions may work for some occupiers and some property types, but there are certain barriers to the universal adoption of turnover rents:

5. KEY FINDINGS AND CONCLUSIONS

Table 5.2: Barriers/Resistance to Turnover-based Leases

Fixed Rent Lease	Turnover-based Lease
Supermarkets will not switch	Retailers do not trust landlords not to use data to increase rent
Fears of higher rent from (successful) retailers, albeit may only be short-term phenomenon	Landlords will need to gain retailer trust for leases outside the 1954 Act, though not apparently an issue in Scotland where Act does not apply
Not suitable for some types of stores, e.g. banks, pharmacies	Landlords cannot rely on retailer-provided turnover estimates
Time will be required to convert existing leases currently within provisions of 1954 Act	Too much incentive for landlords and retailers to 'game the system' on individual deals; need to take away arbitrage opportunity with complete data transparency and standardised terms
Smaller retailers do not have sophistication to provide turnover data; likely that the use of turnover-based leases will vary by property type	Retailers will only supply turnover data if something is received in return

Table 5.3: Bifurcation

Shopping Centres	High Street	Retail Parks
Turnover-based leases only suit where (entire) precinct controlled; otherwise individual landlords always motivated to secure tenant able to pay highest rent for unit, rather than maximise total turnover of centre as a whole	Rents still based on turnover in location, but turnover data only collected to reconcile/determine turnover element	Sector not experiencing over-supply to same extent as other forms of retail and have added benefit of easily transferring to retail/distribution hybrid; fixed rent agreements may be more suitable
Turnover data to be collected at point of sale and in real time, allowing real and effective tenant management	High streets may use turnover data to attract international entrants and to nurture new retailers/formats (not a new concept but more necessary currently due to increase in vacant space)	

5. KEY FINDINGS AND CONCLUSIONS

The principal theme from a landlord's perspective is that turnover rents are only suitable where the investor holds a significant number of properties and where they have control of the environment:

Table 5.4: Suitability of Turnover-based Rents: Influence of Scale & Control

		Multiple control	Single control
Number of units	High	Suitable	Very suitable
	Medium	Unlikely	Suitable
	Low	Not suitable	Unlikely

5.3 Asset Management Models – Movement toward Operational Assets

Traditional Asset Management of shopping centres must continue to evolve to be more management intensive. Property teams within property companies need to blend with retail teams who understand the worth of space to an occupier and the affordability/effort ratios for each retailer type.

It could be argued that, for shopping centres where the precinct is controlled, it could be sensible to move the management basis to that of an outlet centre, where such centres are run more operationally (meaning that management and the leasing structure must change). As these centres become run more operationally, the valuation of them must change as a consequence. Currently, shopping centres are valued on an implicit capitalisation model as their income is deemed to be 'net' with income predictability, whereas outlet centres are valued on an explicit DCF model as they are 'operational assets' (IPF 2021).

This move may require management skills that are more akin to those of a retailer (especially if leasing on turnover rents) than a traditional asset manager whose training and work experience is likely to be from a surveying background. The move towards operational assets requires a new skill sets for investors with both negotiation skills and business analysis needing to be enhanced (IPF 2021).

It also means that, like outlet centres, there needs to be a degree of consistency in both the turnover-based leases and the definitions of turnover.

5. KEY FINDINGS AND CONCLUSIONS

Table 5.5: Implications for Management

Shopping Centres	High Street	Retail Parks
As more tenants move to agreeing genuine turnover-based leases, mutual benefit for landlord and tenant to develop a more proactive partnership where information is shared on a formal, regular, basis	Where in single ownership, possible to manage parade/ portfolio in similar fashion to shopping centre but unlikely to be sufficient critical mass to move towards outlet model	Little change to management
Fixed rents will need to be linked to affordability with prospect that shorter leases will be agreed, possibly with annual uplifts linked to inflation		

5.4 Definition of Turnover Rents

Turnover definitions need to be explicit so as to be transparent and fair to both sides. It may never be able to measure/agree the halo effect. Landlords may just have to accept benefit of in-store sales resulting from click-and-collect and capture this within the base rent.

Alternatively, industry wide standard terms for what is included and excluded from different turnover definitions are required to enable a comparison of one agreement with another. For this to happen there will need to be agreement on the various P&L lines that make up turnover. For example:

i. **Turnover** – in-store;

ii. **Turnover** – online (all);

iii. **Turnover** – online (within geographic region);

iv. **Turnover** – online (collected in store);

v. **Turnover** – ordered online but in-store, e.g. some retailers process all orders through its website from the in-store terminals, and then distributes to the customer if they have the stock, or the order it in for collection the next day from another store, or the customer can have the item delivered to their home; and

vi. **Returns** – as defined by the sales lines above.

5. KEY FINDINGS AND CONCLUSIONS

5.5 Market Data Accuracy, Interpretation and Sharing

Now may be the time, if there ever is one, to collect turnover data and use turnover rents more widely, particularly when landlords are having to make rent concessions. This should include real-time point-of-sale turnover data by retailer category, and possibly other breakdowns.

Market data, such as MSCI indices, report equivalent yields for shopping centres that are significantly higher than the initial yield, implying that there may be substantial reversionary potential, while vacancy rates are being kept relatively low with units being let at zero rents as this helps landlords incurring irrecoverable service charge costs and rates.

5.6 Comparable Evidence and Assessing Aggregate Market Rent

A move towards comparison by affordability of occupier and not simply location and unit size

The importance of correctly assessing the market rent that will be payable at reversion cannot be understated; the majority of the value of an asset lies in the capitalisation of the Market Rent into perpetuity at reversion. An overestimation of the Market Rent will lead directly to an over-valuation of the asset and vice-versa.

All valuers in the survey agreed that the use of ITZA as a means of comparison to determine Market Rent (previously known as ERV) is slowly declining and, in time, will no longer be valid or used by them. The reason for this is twofold. One is the impact of the turnover element in the lease agreements that are difficult to model using arithmetic zoning. The second is that relative location is less important and is being replaced by likely occupier type and thus a move away from zoning towards an overall rent per square foot based upon the affordability of the occupier type.

ITZA may still be used by other valuers who are not so directly involved in the changes happening in the retail sector. Whilst its disuse is accentuated by the move to rents with a turnover element, it is actually the acceptance that rent will vary for different occupiers and not just by distance from what was considered to be the best location that was driving this change. There are therefore two issues to be considered:

1. What is the Market Rent of a unit where there is a turnover element of rent contributing to the overall rent in the future?
2. What is the appropriate Market Rent, on a fixed rent basis, relative to the likely occupier or subset of occupiers for that property?

In the case of the former, the Market Rent is determined by the turnover rent percentage by category as set by the valuer and informed by data from the landlord. The passing rent would then sit above or below this level depending on (1) the actual turnover achieved and (2) the extant lease terms. As more data is evidenced and shared, this would seem like a reasonable approach.

But for the latter issue, It may require all units to be categorised into designated uses/occupier type and the Market Rent would apply having regard to the space in question as determined by the likely use. It is the equivalent of assessing the rent where there is a restrictive user covenant albeit, in this case, it is not legally binding and is a valuer/investor assumption.

5. KEY FINDINGS AND CONCLUSIONS

A significant observation was that the basis for comparable evidence for valuers has now changed. Today, there are a finite number of occupiers for any given 'destination' – the neighbouring shop may achieve a rent of £x, though that does not mean there are sufficient occupiers available to occupy that space (at such comparable rent) without affecting the tenant mix of the destination i.e. a saturation point. The rent for the property will be determined by its use and it may be that identical shops have different Market Rents accordingly.

For example, in any town or shopping centre, there may be 5 high street banks, 20 fashion retailers, 3 hair salons, 2 charity shops and 5 F&B operators. These 35 occupiers may pay a combined £xm in rent to occupy 35 shops out of a potential 50. That does not mean that the remaining 15 shops can achieve a comparable rent to the occupied 35. The excess either remains vacant or is occupied by other lower paying (or zero paying as we are witnessing now) occupiers. With such an over-supply of space, this is not just a function of affordability by the tenant but also the negotiating stance of the parties at that time. Until demand and supply are more evenly set, then there is likely to be downward pressure on rents until the lowest (partly affordability driven) common denominator is reached for each possible retailer type.

In other words, Market Rent should be set at the aggregate retail precinct level (Aggregate Market Rent), not a single (or zoned) Market Rent for a hypothetical tenant; it will be set within the context of the precinct based on the affordability of each tenant type, as well as the existing occupation of such. It might be possible to have comparable market rents for whole precincts, calculated with reference to a comparison of similar precincts and then to determine the Market Rent of an individual store accordingly. However, this will require the valuer to make specific assumptions about that likely occupier. This is not dissimilar to the valuations of properties with restrictive user covenants, or housing with regulated tenancies, but this time it will be based on an expert opinion and not only a legal agreement.

If viewed in the context of other operational assets, such as hotels, on any given night there can only a maximum number of rooms that are occupied (excluding the effects of seasonality). That does not mean that the room rate will decrease to occupy all rooms, but rather to maximise the rent that could be achieved from those occupants. There will always be vacancy, which is allowed for as a cost and thereby decreasing the valuation of the asset. Such a pricing and vacancy strategy (by room type) is the bedrock of hotels, and is virtually identical to the airline industry. In short, the 'sum of the parts' must be considered.

Without making too fine a point of this, the current model of retail valuation is akin to that of a valuing a hotel based on the on the comparable room rates per night that might have been achieved, assuming 100% occupancy (i.e. no vacancy), with no allowance for any occupancy costs, and capitalising that 'gross' rent. In a market where comparable evidence is somewhat opaque in its breakdown, this has the potential to lead to significant mis-calculation of value.

5. KEY FINDINGS AND CONCLUSIONS

There is also a lack of consistency in the determination and analysis of market rents, mostly within retail. There is a lack of transparency regarding the treatment of rent-free periods, landlord contributions, and in particular, whether rents are inclusive of occupancy costs (such as service charges, marketing and rates i.e., gross vs net rents (where net FRI leases are assumed to be the market norm) etc., and at what point a turnover rent constitutes Market Rent (i.e., how often is this referenced as part of the total income that can be achieved for a rentable space).

And lastly, and this may be a reaction to the rebasing of rents noted below, it appears that a majority of valuers regard the turnover element of any rent to be de minimis and may ignore it when assessing value (on the assumption that it will either not be received at all or that it is very low). This is further exacerbated by a lack of transparency in comparable data, so a valuer may not know its true 'materiality' when valuing the asset.

There is also the issue that, to understand market evidence in relation to turnover rents, there is a need for combined knowledge of the retail market as well as knowledge of valuation. Combined, this is a new skillset required for the valuer to determine Market Rent.

Table 5.6: Implications for Valuers

Fixed Rent Lease	**Turnover-based Lease**	
	Rebasing of Market Rent or CVA provision	Genuine Share of Turnover
Fixed rents to continue to be valued using implicit model unless centre as a whole has moved to predominance of turnover rents – in which case, full valuation will use explicit model Market rents to be based on likely occupier type and , in turn, effort ratio, not by tone for whole centre	Although owner will confirm when a turnover rent is received, valuer will need to determine likelihood of turnover element of rent being received in future years, which is often considered too remote to include in valuation and only base rent will be valued	Will require landlord to share turnover information with valuer; valuation to move away from comparison approach to valuation of actual income flow, with reversion determined by occupier type as rents will vary according to user. Likelihood that valuation will move towards explicit model **High Street** Implicit valuation model likely to be retained with turnover rent being valued as part of expected cash flow

5. KEY FINDINGS AND CONCLUSIONS

5.7 The Re-basing of Retail Rents and Capital Values

One of the central themes of all the discussions was the fact that retail rents were being re-based in the UK – a long overdue, and not insubstantial, correction. Respondents who worked in the continental European market stressed how much lower total occupancy costs were in the European markets. Most retailers shared turnover information even where there was no turnover element to the rent but, by doing so, the landlords gained an insight into the affordability of the rents being set for each occupier.

Thus, in some cases, it may be that the introduction of a new lease with a base rent and turnover element is simply a market mechanism that psychologically eases the dramatic rebasing of retail rents as market dynamics will not lead to the turnover element ever being paid.

The counter-argument proffered by many of the respondents was that, apart from CVA agreements and a few F&B agreements, most turnover-based leases were not 100% based on turnover. The norm was a fixed base rent in a range of 70-80% with a top-up of turnover on the remainder. But, in a market where retail turnovers at the physical shop level are falling each year, the comfort of a potential turnover rent top-up is actually unlikely to materialise.

Therefore, the impact on the valuation may be minimal as the majority of the cash flow for most centres will remain one of a fixed income, albeit in a different guise.

It is likely that many turnover agreements are simply a way to rebase rents over the short to medium term and that current market rents (for the reversion) are being assessed on historic data and will simply not be achievable. This will lead to over-valuations.

It is possible that rents will fall in the future to below the base rent (where the base rent if set to 80% + of the total rent including turnover rent) – leading to problems with any leasing regime that doesn't allow downward movement in the rent. The nature of a base rent is that it might not really be that flexible. It is therefore imperative that the base rent is fixed at an affordable level. Crucially, this means that landlords, valuers and agents alike need to understand affordability.

Traditional valuer assumptions are not capturing the plethora of specific ('bespoke') agreements for individual spaces on shorter term agreements. The implicit valuation model is not good at capturing this individuality as it requires the valuer to have more detailed information of the lease agreements which is not necessarily always available.

If valuers are to start to adopt explicit models for centres leased on turnover rents, then they need to capture both the turnover element that will be paid and the change in the base rent if linked to inflation. Explicit DCF models can more robustly capture the cash flows which an implicit valuation model cannot.

Valuers will need a lot more data on retailer turnover by category/scheme type. And it will need to be verified and benchmarked. Anecdotal evidence is just simply not sufficient or robust. Either, specialist valuers must emerge, that have access to data on turnover levels by retailer category in scheme type/location or third-party data intermediaries will emerge.

APPENDIX A. VALUATION APPROACHES, METHODS AND MODELS

A1. Introduction

Property valuations in the UK and internationally are undertaken in accordance with the International Valuation Standards (IVS 2021) published by the International Valuation Standards Council (IVSC)[13].

The IVS refer to Valuation Approaches and Valuation Methods and, as an implied subset of the methods, techniques or models[14]. The IVSC recognises three approaches (Income, Cost and Market) that are all based on the underlying economic principles of price formation. The appropriate basis will vary depending on the purpose and nature of the valuation. Each of these principal valuation approaches includes different detailed methods of application and within these methods, there are different models. So there is a hierarchy: approaches are a set of broad over-riding criteria for the valuation; the method is the more detailed framework for the calculation; and the models are the exact mathematical technique used.

The hierarchy within the IVSC standards follows the convention:

Approaches

1. **Income:** The income approach provides an indication of value by converting future cash flows to a single current capital value;
2. **Cost:** The cost approach provides an indication of value using the economic principle that a buyer will pay no more for an asset than the cost to obtain an asset of equal utility, whether by purchase or by construction and;
3. **Market:** The market approach provides an indication of value by comparing the subject asset with identical or similar assets for which price information is available.

Methods

1. Comparable Method (Market Approach);
2. Depreciated Replacement Cost (DRC)/Construction Method (Cost Approach);
3. Investment Method (Income Approach);
4. Residual Method (Income Approach); and
5. Profits Method (Income Approach).

Models or Techniques

A valuation model or technique is the mathematical model used to determine Market Value. For example, with the Investment Method, the valuer can choose an implicit or explicit model. The pertinent question is which model should be chosen for assets with a turnover element?

[13] For valuation in the UK, the International Valuation Standards are incorporated in the RICS Valuation – Global Standards and the UK national supplement (RICS, 2020)

[14] Price formation is an information-gathering process that ensures that market participants have sufficient knowledge of the prices of the assets being traded in the market, so that they can make well-informed decisions. The price formation process is a central ingredient to well-functioning markets

APPENDIX A. VALUATION APPROACHES, METHODS AND MODELS

Thus, when valuing a property, the valuer must decide upon the appropriate approach, method and model. For any existing asset that produces a cash flow, the appropriate approach is the income approach. And, assuming that the asset is not a development opportunity, then the valuer needs to decide upon using the investment method or the profits method.

A2. Valuation Modelling

Possible models for the valuation of turnover-based leases

All valuation methods are an attempt to determine Market Value. The specific mathematical technique chosen to do this is known as the valuation model. All valuation models capitalise future expected cash flows. This can be done implicitly or explicitly.

a. The implicit model captures the attractiveness of the investment, including all risks, by capitalising the current net rent to determine the Market Value. The multiplier used is the inverse of the capitalisation rate; the more attractive the investment, the higher the multiplier and the lower cap rate. The yield, known as the All Risks Yield (ARY[15]) in the UK, reflects an opportunity rate of return plus risk and expected growth. This is the capitalisation model.

b. Conversely, an explicit model forecasts the expected future rent and property expenses as a cash flow and discounts these cash flows at a yield that only reflects the opportunity cost plus risk. Any growth is captured in the cash flow. This is known as the Discounted Cash Flow (DCF) model. The term for the DCF yield varies according to the user. Some refer to it simply as 'the discount rate', some as 'the required rate of return' and others as a 'target rate' or expected Internal Rate of Return (IRR).

The advantage of implicit modelling is its apparent simplicity and the availability of the relevant data from comparable evidence. Yet, for many assets, explicit models are more akin to the way in which property owners analyse the worth of their assets. And although worth and value are different concepts, there is a strong argument that the valuation model should reflect the investor's worth (or 'underwriting') calculations in the market.

The choice of valuation model does however rest with the valuer. If an implicit model is considered the best model for determining Market Value, then that should be the chosen valuation model. However, if a DCF model is more appropriate for the asset's cash flows this should be used.

[15] Where properties have an expected change of income, in current day terms, during the lifetime of the investment the capitalisation model may use different yields on the different tranches of the income. The average of these ARYs is referred to as the Equivalent Yield.

APPENDIX A. VALUATION APPROACHES, METHODS AND MODELS

A3. The Use of Implicit and Explicit Models

Comparable Evidence and Yields

The choice of valuation model is generally a reflection of the data available and the complexity of the expected cash flows.

Implicit Model

The implicit model is actually a model based on comparison. Where rents are yet to be agreed, the likely Market Rent[16] is estimated by reference to other recent leasing activity of similar properties in the same location. Likewise, the ARY is derived by analysing recent sales of similar property assets. This determines the Net Initial Yield (NIY) for the asset type in that location which, when adjusted, becomes the ARY[17] for the valuation. In reality, valuers 'decapitalise' recent comparable sales to derive the NIY and adjust this (intuitively) to reflect recent changes in the market, and apply this multiplier to the subject property. The implicit investment model is now one of simple comparison.

Explicit Model

Likewise, the DCF model derives the Market Rent in the same way as the implicit model, but in addition, determines growth with reference to decanted market expectations, again by comparison. The choice of the relevant discount rate is also a market derived rate, although this time with reference to a consensus view of similar investors' required rates of return for such assets. The DCF model, as the name suggests, projects expected cash flows, including any growth, and discounts the (explicit) cash flow at the chosen rate. The explicit investment model mirrors the likely analysis of the investor to determine the worth of the asset.

Regardless of the valuation model chosen, both techniques are trying to determine Market Value, and thus both the implicit and the explicit models' answers should be the same. In each case, the basic model is one of a cash flow and a discount rate.

Both models need to capture the following within their calculations:

i. Initial rent;
ii. Growth;
iii. Costs;
iv. Voids;
v. Risk free rate;
vi. Risk (liquidity, transparency and volatility); and
vii. Depreciation.

The difference is in how each model reflects these elements and this is usually determined by the availability of comparable data. Thus, one of the issues facing valuers of all property types, in particular properties where there is volatility in the income (e.g. turnover rents), is the availability (or not) of comparable evidence and datasets referenced by valuers.

16 The term Market Rent is the internationally accepted term for the best rent readily achievable in the market at a specific point in time. Its full definition is contained within the Royal Institution of Chartered Surveyors (RICS) Global Valuation Standards (colloquially known as The Red Book). It is recognised that market convention still refers to this rent as the Estimated Rental Value (ERV) but this report will refer to the RICS terminology.

17 There is an inverse relationship between the ARY and the multiplier used on the rent. In the UK, the multiplier is known as the Years Purchase (YP) and for a property let at Market Rent is 1/ARY. Thus the capitalisation of the initial income at a lower yield dictates a higher multiplier and a corresponding higher market value.

APPENDIX B: SURVEY OF CURRENT PRACTICE

B1. Aims and Objectives

To identify current trends in the use of turnover rents, the approaches, methods and models taken to their valuation and the comparable evidence and datasets available to the valuers, a survey of the UK's largest property valuation houses, leading retail agents and largest investors was undertaken in May 2021. Participants were principally UK-based, with some additional responses received from US and Continental European counterparts within these valuation houses.

B2. Questionnaire and Process

The survey method chosen was a mix of questionnaire and interview. It was important that this research obtained an expert, informed and considered opinion of the principal players in the property market. It was decided, therefore, to target the main property valuation companies, the main investors in real estate (and specifically shopping centres and retail parks) and the major agents and legal firms representing landlords and tenants in negotiating turnover-based leases.

The research targeted 10 valuation houses, 16 agents/lawyers and 18 investors/owners. The valuer questionnaire is available on request from the authors. Questions posed to the other groups were very similar but tweaked to draw out the specifics relating to their active role in the market.

In addition to the 10 UK valuers, the authors also contacted five of their North American colleagues, as it had been suggested they had more experience of turnover-based leases. This was seen as a separate survey[18]. In addition, three UK valuers passed the questionnaire to colleagues who predominately valued retail property in continental Europe.

Given that the majority of the survey work was qualitative in nature, the Delphi method was adopted as the research model, to identify consensus views on specific topic areas. This is particularly useful when targeting knowledgeable participants and suited to areas of research subject to rapid change or where there is a lack of clarity. The approach is to question experts in the field, analyse and aggregate the results and present the results back to the same participants (or a subset of the same universe) to determine a consensus viewpoint.

In the case of this survey, the questionnaire was Part 1 of the process and the interviews, where the results were presented back to the participants, Part 2.

18 The results of the North American Survey (not included here) were surprising at it revealed that fixed rents agreements were much more prevalent in the USA and Canada and that those markets were moving towards turnover-based leases at the same time as we are experiencing an increased in the UK. (Turnover rents in North America are referred to as percentage rent.)

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B3. Participants

Respondents to the survey represented each of the major UK valuers although a number of them completed multiple responses for different locations in the UK and across continental Europe. They comprised:

- Avison Young
- CBRE
- Colliers
- Cushman and Wakefield
- Eccleston Capital/Total Turnover Solutions
- Gerald Eve
- JLL
- Knight Frank

Together, the respondents valued properties with a combined market value in excess of £40bn.

The survey also sought the views of major investors/owners and key retail agents. The respondents were from the following firms:

Retail Agents and Legal Firms

- BNP Paribas
- Freeths
- GCW
- Harper Dennis Hobbs
- MMX
- Innes England
- Realm & Total Turnover Solutions

Owners

- abrdn
- CBRE Investment Management
- DWS Alternatives Global Ltd
- Grosvenor
- Legal & General Investment Management
- New River Retail

After the initial survey results were compiled, follow-up interviews were conducted with a cross-section of contributors, in order to corroborate responses and invite further reflections on them, as well as obtain confirmation that the consensus of opinions drawn from the questionnaire results were accepted.

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B4. Questions

Three different questionnaires were designed and tested for the different players in the UK market; Owners/Investors, Valuers and Agents/Legal firms. Whilst, many of the questions were tailored to each group, there were a number of questions that were repeated on each questionnaire. In that way, the authors could gain an insight in to the market regarding the same issue but from different viewpoints.

The results of each question are noted below with comments from the respondents both from the questionnaires and the follow-up interviews shown separately.

All questionnaires asked about the extent of the use of turnover rents by sector. It was clear that the increased use of turnover-based leases was, in the main, restricted to the retail sector. Therefore, the analysis has concentrated on the results for the high street, retail parks, shopping centres, leisure and restaurants/F&B.

B5. Comments from Follow up Interviews

In addition to the results summarised in Section 3, attributed comments from follow up interviews (and questionnaires where noted) are documented in this section.

B5.1 Motivation for the use of turnover rents

Valuer

- In the UK there has been a resistance to turnover rents as most occupiers don't wish to share turnover data. It is the market change that has been accelerated by covid which has, mainly for fashion retailers, moved towards turnovers. This has been either via CVAs or to avoid empty properties with existing and new tenants being offered turnover-based leases to entice them to keep/take the space.

Retail Agents

- For a while, all deals were ones of desperation with covid deals blurring the already falling market. There is less desperation now that lockdown has passed but the market is still oversupplied. Many retailers are dismissing space in some poor locations or schemes so landlords are offering zero rent deals to get some occupancy.
- On the high street turnover rents are just a comfort mechanism to allow rents to rebase.
- Retailers are interested in total occupancy costs and effort ratios (occupancy/turnover). Retailers who have been exposed to the outlet market they can see the benefits of the model. It is all about sustainability of income in all markets.

APPENDIX B: SURVEY OF CURRENT PRACTICE

B5.2 Temporary or structural shift?

Valuers

- This is definitely a structural change in the UK.
- There are going to be some categories of tenant that won't want a turnover lease so there will be a mix of lease types based on operator type.
- This is a structural change for shopping centres but less so for out-of-town and high streets.
- This is definitely a structural change in the UK. In Europe, there is a slight move towards more turnover rents but less so as rents in Europe are much more reasonable and, as such, there is less likelihood of bankruptcies and CVAs (or equivalent).

Retail Agents

- The market will split. Some will be managed on turnover but some will be a fixed rent by another name. Managed retail environments will benefit from turnover rents and it will become the normal with a two-way process of shared data.
- There will be strata of different retailers wanting different models of leases. Some will want showrooms on fixed rents, some will want turnover leases and some will want fixed rents.

B5.3 Do you think that turnover rents can/do lead to higher income over the long-term?

Owners/Investors

- The introduction of turnover-based leases is a transitional mechanism to move towards much lower rental levels. There is a massive structural decline and it would be inappropriate to suggest it was not happening. The question is what is the best model to manage that decline and the turnover lease at least allows a little hope of higher rents in good trading positions.
- Turnover rents are the best way to secure the highest possible rent from a property. But that will require, for shopping centres, landlords to spend money on the centre to align the business models of the occupiers and owner.
- Turnover data informs the leasing strategy and that can lead to a better managed asset so indirectly it can lead to a higher income dependent upon the individual operator.

B5.4 Do turnover rents lead to higher volatility?

Comments from Questionnaires

Valuer

- It is impossible to get away from the fact that turnover-based leases introduce more volatility in income and there is no way to avoid that as they are designed for the landlord to share in the risks faced by the tenant.

Owner

- A key dependency is the level of the base rent: too high risks affordability issues down the line, whereas too low shifts more of the sales volatility onto the landlord (great in economic upswings, but more negative in recessions).

APPENDIX B: SURVEY OF CURRENT PRACTICE

B5.5 Do turnover rents lead to a stronger covenant?

Comments from Questionnaires

Valuers

- They aren't connected. You could have 100 perfect leases but the retailer themselves go bust because their business overall loses market relevance or the business is run poorly.
- They can't improve the covenant strength, but they can improve the visibility to enable landlords to take action on poorer performing stores and to assess where affordable rents sit for various operators.

Owner

- Covenant could become stronger because there are fewer fixed overheads and outgoings would ebb and flow in line with their business.

B5.6 Do turnover rents lead to higher income, higher volatility or a stronger covenant?

Valuers

- In practice the turnover lease means that the income is less likely to disappear albeit that the income cash flow itself might be volatile in itself. But it avoids catastrophic losses of all income as no CVAs and bankruptcy. So, overall, it is a lower volatility.
- A rent linked to turnover is more stable. High fixed rents cause retailer failures. A lower reasonable base rent with a turnover element means that there is confidence in the rent being paid in the future.

B5.7 What is the Market Rent?

Valuers

- Tenant incentives are confusing to determine to calculate a headline rent. Historically, there was a rent free period of 3 months but there are now so many 'offers' to keep tenants in occupation.

Comments from Questionnaires

Valuers

- Turnover rent incorporated if thresholds are met.
- Market Rent is derived by comparison; net turnover track-record (last 3 years) and OCR (Occupational Cost Ratio) benchmark in order to arrive to the Market Rent.
- In determining the net Market Rent we compare the base rent plus turnover percentage position against the traditional Market Rent approach.
- Tend to do headline and package reflecting market reality that rent reviews are almost redundant.

APPENDIX B: SURVEY OF CURRENT PRACTICE

B5.8 What yield do you use on the turnover element in the valuation?

Comments from Questionnaires

Valuers

- In implicit models the turnover rent is normally split out and a higher yield is adopted to the turnover element based upon our assessment on the level of base rent (affordability), performance of the tenant and any track record on turnover rent for that unit.
- This is determined case by case, and not necessarily separated out every time – but the top slice is generally considered higher risk than the base rent and so will be capitalised at a higher yield than applied to the core income.
- It depends on the style of the turnover lease and the proportion of turnover rent. We tend to use an ARY (All Risks Yield) but we do use different yields if the turnover rent is a top slice and highly variable.
- Typically, the proportion of turnover rent is minimal and therefore impacts little on our overall approach to determining yield. Typically our comparables have similar profiles.
- In Europe, the same yield used on both elements as any investment comparable transactions are analysed adopting the same level of yield.

B5.9 Do you assume growth in the turnover element in the valuation for the Explicit Valuation model?

Comments from Questionnaires

Valuers

- Rental growth will default to CPI.
- We calculate an estimated growth rate for income according to the GDP and private consumption projections for the country in question.
- From a view on what the likely rental growth projections are for the particular unit.

B5.10 Do you value turnover-based leases by DCF?

Comments from Questionnaires

Valuers

- We would sometimes use a DCF to check the validity of the implicit model. This is only on particularly complex assets.
- This is the principal calculation used in continental Europe for valuing multi-let retail.
- In Europe, the traditional method is usually the ‘check’ rather than the principal valuation method.

APPENDIX B: SURVEY OF CURRENT PRACTICE

B5.11 Do you use in-house Excel (or equivalent) valuation templates, bespoke valuation software created for you or generic, off-the-shelf, valuation software?

Valuers

- Using in house excel spreadsheets. In Germany, Argus Enterprise (AE) is used. They have an internal model that works with AE. But generally, valuations across Europe are done by explicit DCF models on Excel.
- AE and implicit models are used primarily in the UK. In Europe Excel DCF models are predominately used although a few international clients do ask for AE.

B5.12 Do you use workarounds in generic software to value the property?

Comments from Questionnaires

Valuers

- We frequently use workarounds. Understandable as there is no set turnover standard across UK or even across EMEA.
- The in-house and bespoke software is set up to value turnover rent explicitly in any manner of turnover lease.
- The software has already been sufficiently adapted for turnover rents.

B5.13 Are you provided with turnover data for undertaking valuations?

Valuers

- It is still difficult to get all the turnover data in the UK. It is very patchy particularly as many owners feel that their NDAs with their tenants means that it isn't OK to pass that to the valuer. In Europe, it varies. Germany and France and the Nordics are very good at providing turnover data as are the centres in the middle east.
- Turnover Information is not readily available. But it is difficult to project turnover. Purchasers generally do not believe turnover projections provided by tenants.
- If we had the info, we would be able to provide a better service to the clients. But many landlords are unwilling to provide the information. They get a mix of standard leases and turnover-based leases and some of those have a turnover rent payable. But landlords often only give info when the threshold has been passed.
- 'Yes' in Europe; 'No' in the UK. And where it is provided in the UK, it is always in arrears through verified accounts that may be 12 months or more old. In Europe, it is common for the shop tills to be linked to a central database so sales are in real time. This is the same model in Australia. Turnover data is provided in detail.

APPENDIX B: SURVEY OF CURRENT PRACTICE

Comments from Questionnaires

Valuers

- We receive very little data, as do the owners. This is the reason why UK landlords are reluctant to take on turnover-based leases as they feel they are negotiating blind with the tenant and do not have enough information available to ensure they are being fairly treated. With time, as turnover-based leases become more widely used, the data will be improved and this problem will not be an issue but right now at this point in time it is much more challenging.

B5.14 Are you restricted in your choice of valuation model due to a lack of data?

Valuers

- In the UK there is a nervousness and lack of cooperation about providing turnover data as there is no track record in the UK of providing data.
- There is not enough data and the quality of available data is questionable for shopping centres. Oddly, some retailers will provide turnover data in the Europe but not in the UK. The UK market is seen to be different.

B5.15 Please indicate the market data that you feel is available for both implicit and explicit valuation models?

Valuers

- Normally there is information available in shopping centres in Europe. Not hampered by a lack of data. Enough benchmarks to fill in gaps where specific data is not available.
- Property data is there for most main assets in the form of rents and yields. But how reliable is that data since covid is questionable. The valuation is based on available data. Market Rent comparables still available but they can't be taken on face value.
- Property data is there for most properties but it varies for different properties. Without turnover data, it is more qualitative analysis and professional expect judgement. But we are struggling with benchmarks. It is missing in the UK.

Retail Agent

- Data is power and being used in negotiation, so there is inertia in moving towards to share data

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Paper from sustainable sources