IPF

RESEARCH

At a Glance

APRIL 2022

Turnover-based Leases – The impact on the Worth of an Asset

The move towards turnover-based leases has been widely reported, though with little accompanying analysis of the variation in their terms or the impact on the worth[1] of the underlying asset. This research considers the implications for investors that may result from a move to this type of lease.

Method: analysis of worth

The research compared the Worth of an asset leased on fixed rents versus that leased on turnover-based rents under different scenarios and looked at the impact of each on either the expected All Risks Yield or overall discount rate.

Worth Estimate (i.e. gross value)

Solve for All Risks Yield (Implicit model)

Solve for Discount Rate (Explicit model)

Drivers: key factors acting in unison that most positively impact worth

i. Moving to a base and turnover rent;

ii. Moving to a shorter rent review cycle; and

iii. Facilitating more active asset management, which reduces vacancy periods and associated costs.

Positive and negative impacts

The lower the base rent percentage, the lower the Worth due to:

- the loss in protection from rental falls; and
- an increase in the volatility of the income stream.

The more effective the asset management, the higher the Worth due to:

- shorter vacancy periods;
- higher lease renewal rates; and
- lower tenant default rates.

The benefit of improved leasing outcomes is estimated to potentially outweigh the reduction in Worth from leasing on a turnover basis.

Turnover rents can lead to higher cash flows but will result in greater volatility

The move towards Turnover-based leases means that both landlord and tenant share risk of upturns and downturns in the market – in good markets, the rent will be the base rent plus a percentage of the turnover, in a poor market, it is unlikely that the turnover trigger will operate and thus only the base rent will be received. There is potential for higher overall rents tempered by greater volatility in the cash flow, therefore.

[1] "Worth" being defined as subjective assessment of the attractiveness of an investment to a specific investor, based on their judgement of the future cash flow, discounted at a rate that includes an allowance for the investor's tolerance for the risk of the asset in a portfolio context.

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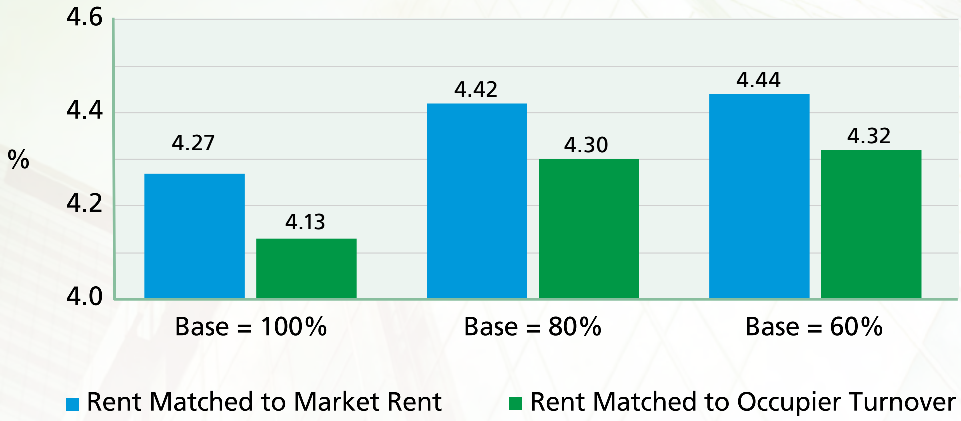
Results

Impact of Matching Rent to Turnover, 5-year Leases with Annual Reviews



If turnover is high, then the rent receivable exceeds the Market Rent ('unsecured income'). If turnover is low, then the rent receivable is below the Market Rent (lease reversion). The lease reversion is limited from rising by the Base: the higher the Base percentage, the lower the rent lost due to deficient level of turnover. Hence, the upside from a turnover-based lease is not "capped" but the downside is subject to a "collar"

(determined by the Base percentage). Gross Value is enhanced therefore by the use of a turnover-based lease, and the more so the higher the Base percentage.

Turnover rents can lead to fewer bankruptcies/administrations

- The advantage of a turnover-based lease is that the rent payable is more directly linked to the affordability of the space to the occupier.
- This means that occupiers are able to navigate the volatility of the retail market more ably resulting in a reduced rate of bankruptcy, administration, continuity in the cash flow, and a secure base rent for the landlord.
- As market rent is assumed to be determined ultimately by a tenant's turnover, the long-term growth in income is either unaffected or boosted by the ability to replace poorly performing retailers with stronger ones through improved active management.

Turnover-based leases place more emphasis on asset management skills and stock selection than fixed-rent leases.

The full report may be downloaded from the **IPF website**