IPF

RESEARCH

OCTOBER 2021

Turnover-based Leases

Issues, Drivers and Challenges: A Survey of Current Practice

SUMMARY 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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Introduction and 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.[1]

Turnover-based leases have been in use in many sectors of real estate across the world since the 1970s. The principle of a turnover-based lease is that all or part of the rent is based on an agreed percentage of the turnover or EBITDA of the business carried out from the property. In some cases, 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. In all cases, the amounts agreed are negotiated between the landlord and the tenant.

One of the economic impacts of the COVID-19 pandemic has been to accelerate trends that were already underway in many property sectors, albeit at a much slower rate. One such change has been the move towards a greater use of a turnover component to rents in response to the diversion of sales online. Initial indicative evidence, prior to this research being undertaken, suggested that this was affecting all property leasing to some extent, but the results of the survey undertaken as part of this study suggest that the increased use of turnover-based leases has been confined almost exclusively to the retail, leisure and restaurant/F&B sectors.

This report (Part 1) looks at the prevalence of turnover-based leases, the likelihood of them being permanent or temporary features of the market and the implications, in both cases, on valuation modelling and investment decisions. A second report, to follow in late 2021, will focus on the implications of turnover-based leases for the calculation of worth for investors.

Aims and Objectives of the Research

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.

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

Its 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?

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

To cast light on this evolving situation, a survey of UK valuers, agents and owners/investors was undertaken in May 2021.

The Current Market

Turnover-based leases link a proportion of the rent received directly to the turnover of the retailer from the individual store. Previously, the predominant approach was a fixed rent leasing model where a rental level is agreed at the time of the initial letting and then re-based to the rental level achieved on comparable stores at periodic rent reviews and at lease renewal. The impact of Covid 19 has accelerated market trends in retailing with a significant move towards online sales.

This switch from bricks-and-mortar to online consumer spending has been eroding retail sales dependent purely on physical locations at an exponential rate, and significantly reduced the current economically sustainable rent for retail property.

Turnover-based Leases – 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 trigger mechanism that guarantees the base rent or 100% of the turnover as a turnover rent, whichever is the higher.

Within these specific arrangements 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:

d. Base rent – the fixed amount of rent that is paid;

e. Turnover – the turnover of the tenant, subject to definition;

f. Turnover threshold – the amount of turnover at which a turnover rent becomes payable;

g. Turnover rent % – the percentage of turnover for which a turnover rent is payable;

h. Duration of any turnover rent; and

i. Whether the rent is inclusive or exclusive of service charge and/or rates and other expenses such as marketing.

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 stronger retailers.

A disadvantage is that the lease is more complex, coinciding 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, which landlord have accepted in the past but, with multi-channel retailing, these certifications are increasingly being questioned and/or challenged by landlords.

A fixed rent without any turnover element is more certain, and enforceable, for both parties. However, whilst the rent is normally at a level that 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, as the rent may be too high relative to sales at that point in time.

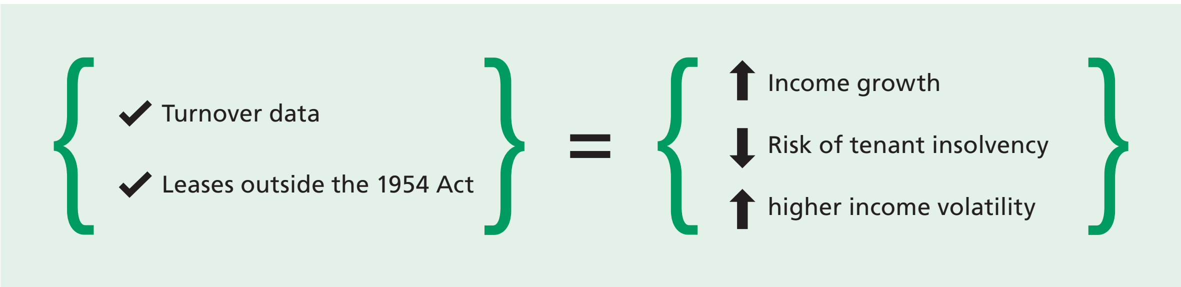
For the landlord, the certainty of the fixed rent in a downturn creates a more stable cash flow than a turnover rent, which will rise and fall. Turnover-based leases therefore result in a transfer of risk from the tenant to the landlord.

Many retailers struggled to maintain profitability, and a number used the Creditor Voluntary Arrangements (CVA) process to close under-performing stores and reduce rents. As part of this process, turnover rents were often imposed on landlords. Whilst a proportion of the move to turnover-based leases may be reversed as the economy emerges from the pandemic and the surviving retailers are able to compete with online sales, the widespread adoption of turnover-based leases as part of a wider structural change in retailing will remain and expand. As such, the mechanics, procedures and data flows of property markets must adapt rapidly to reflect these changes. The change will have implications for both the valuation profession in assessing market value and for investors in assessing the worth of such assets.

Turnover-based Leases – Changing the Risk Profile of the Income Stream

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 as well as worth.

Figure 1: Investment Implications of Turnover Data Combined with Leases Outside the Act



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 the burden of 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, would potentially allow the landlord to 'weed out' weaker retailers before an economic downturn – at the cost of a potential void. The concession of a turnover element in return for a turnover-based lease break may therefore lead to a reduced incidence of tenant default. Further, if weaker retailers are removed before an economic downturn the landlord is less exposed to multiple failures.

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 that 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 fixed rents will become '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 increased annually in line with inflation. With fixed rents, uplifts typically occur only every five years, much 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.

Growth

- Arguably the rent setting mechanism should have no bearing on the actual level of rent, 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. But for this to happen, there needs to be clear definitions and standardised agreements that are accepted and understood by all parties.

The Valuation of Turnover-based Leases

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). The IVS refer to Valuation Approaches and Valuation Methods and, as an implied subset of the methods, techniques or models. 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. 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?

Implicit and Explicit 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.

Implicit Model

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-Risk Yield (ARY) in the UK, reflects an opportunity rate of return plus risk and expected growth. This is the capitalisation model.

Explicit Model

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 expected income 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 as simply the 'discount rate', some as 'the required rate of return' and others as a 'Target Rate' or expected Internal Rate of Return (IRR).

The implicit model is actually a model based on comparison. Where rents are yet to be agreed, the likely Market Rent 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 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.

Likewise, the explicit 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.

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.

Key Findings

In interviews, 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. Many respondents commented it is likely that a proportion of the move to turnover-based leases will be reversed as we emerge from the pandemic. The research found that this was thought most likely in single occupancy out-of-town and retail parks and least likely in shopping centres.

The survey identified eight key themes:

1) Further Striation of the 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. This conclusion was based on the three drivers impacting the increased use of turnover rents;

- The occupier's demand for such a contract;
- The use of any 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. CVAs may 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.

2) The Future Use of Turnover Rents will Vary by Occupier Type and Location

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 the UK; and
- The need for individual, non-UK, agreements to attract international brands who would not 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.
- That owners are proactive in their management and are willing to set rents by reference to the affordability revealed by more turnover data.
- Access to turnover data gives landlords the information to manage destinations (where they control the precinct) more effectively. e.g. trading off car park charges with higher income.
- Landlords 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 to ask for gross rents on space that has already been fitted-out, thereby paying for the flexibility of not requiring, or depreciating, the cost of fit-out.

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[1] 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.

4) All Parties will Benefit from Improved 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 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 to avoid incurring irrecoverable service charge costs and rates.

5) There is a Need for Consistency in Interpreting Comparable Evidence and Assessing Aggregate Market Rent

There is likely to be a move towards comparison by affordability of occupier – 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 relates to the capitalisation of the market rent into perpetuity at reversion. An overestimation of that market rent will lead directly to an over-valuation of the asset and vice-versa.

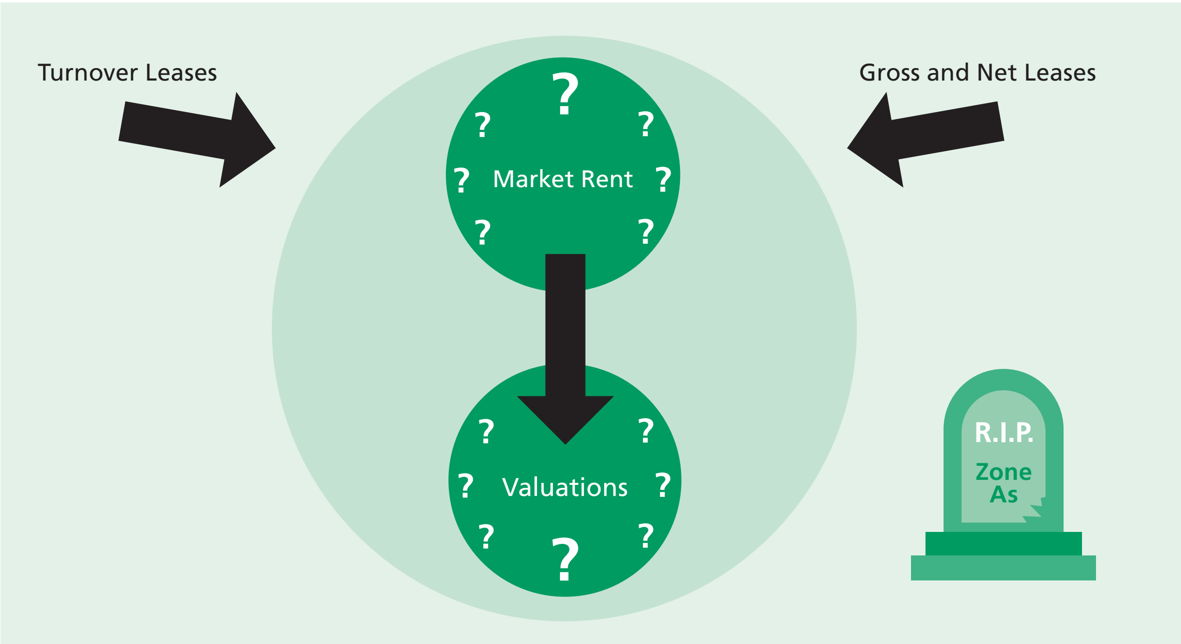
All valuers in the survey agreed that the use of a zoning model whereby rents are compared in terms of zone A (ITZA) to determine Market Rent (or ERV) is slowly declining and, in time, will no longer be valid or needed, or being used by them. The reason for this is twofold: one is that the impact of the turnover element in lease agreements is difficult to model using arithmetic zoning and the second is that relative location is less important and is being replaced by likely occupier type and thus a move towards pro-rata rents by occupier instead based upon the affordability of the occupier type.

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

But 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?

Figure 2: Sources of Valuation Uncertainty



In the case of the former, the Market Rent is determined by the sales turnover and percentage rent 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 sales 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.

A significant observation was that the basis for comparable evidence for valuers has now changed. The rent for the property will be determined by its use and it may be that identical shops have different Market Rents accordingly.

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.

There is an issue with the quotation of rent agreements during the last 18 months: many are quoted on a net basis when, in fact, often the units are being let simply to cover cost such as rents and service charges. These non-recoverable costs need to be deducted from the quoted rent to derive a true net rent.

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 versus 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).

This may be a reaction to the rebasing of rents noted in Table 1; it appears that a majority of valuers regard the turnover element of any rent to be de minimus 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 and its occupiers, as well as knowledge of valuation. Combined, this is a new skill set required for the valuer to determine Market Rent.

Table 1: Implications for valuers

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

6) 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 continental Europe stressed how much lower total occupancy costs were in these 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 that are simply not achievable.

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 does not 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, and not some arbitrary level that the occupier in an effort to broker an agreement in said current market. 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.

7) A Move to Explicit DCF Valuation

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 that an implicit valuation model cannot. But there are a number of things that need to happen.

- The more standard the definition(s) of turnover in lease contracts are, the easier this adaptation will be.
- The more transparency on retailer turnover there is to valuers and investors, and on general retailer turnover to measure net and gross effort ratios (i.e. rent as a percentage of sales), the less uncertainty there will be around valuations.
- 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 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.

8) There is a Need for Greater Clarity in Market Data

In the sectors where turnover-based leases do become more readily adopted, the mechanics, procedures and data flows of property markets will need to adapt rapidly to reflect a higher proportion of turnover-based leases.

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).

- 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 switch to turnover-based leases as the growth is likely, in many cases, to be restricted to the base rent adjustments. 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.

Conclusion

There is likely to be a further striation of retail leases. For some (assets/sectors/occupiers), turnover-based leases will become the norm (for national and international fashion and F&B, for example) whilst other occupiers will revert to fixed rent leases. Whilst a proportion of the move to turnover-based leases may be reversed as the economy emerges from the pandemic and the surviving retailers are able to compete with online sales, the widespread adoption of turnover-based leases, as part of a wider structural change in retailing, will remain and expand. As such, the mechanics, procedures and data flows of property markets must adapt rapidly to reflect these changes, which will have implications for both the valuation profession in assessing market value and for investors in assessing the worth of such assets.

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