REPAIR | Real Estate, Place Adaptation and Innovation within an integrated Retailing system

Policy Brief

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City Centre Real Estate Markets

Changing retail practice and adaptation

Executive summary

While the unprecedented structural changes faced by the UK retailing industry have made for headline news, little attention has been given to the implications for property owners. This is despite the pivotal role they play in providing retailing and other city centre space. Owners are facing a challenging future in which they must respond concurrently to the needs of retailers and shoppers, as well as society more widely. This often involves changes in the use of their properties and to the ways they manage their assets.

This Policy Brief is a summary of a study which examined the interrelationships between changes in property use, real estate practices and localised patterns of urban development. The study formed part of a wider retail research project[1] conducted across the retailing cores of five regionally significant cities (Edinburgh, Glasgow, Hull, Liverpool and Nottingham). The wider project aimed to better understand the adaptive capacity and resilience of city centres.

The study's findings are intended to support policymakers charged with managing urban centres, property owners, and property management professionals by making the following recommendations:

Develop masterplans that approach central retailing areas as single entities, including long-term visions for centre transformation, and improvements in walkability and amenity.

Devise initiatives to encourage greater use diversity and promote land use flexibility in city centres.

Increase transparency in the city centre property market to improve access to data on different lease types, possibly as benchmarks, to enable landlords to assess the suitability (and competitiveness) of terms within a lease. This could lead to the establishment of a 'best practice' turnover methodology.

Improve data sharing on the financial position of tenants to improve the assessment of covenant strength.

Overhaul the valuation model and retraining for professional valuers to better capture changes in retail leases.

Increase support for independent tenants with less property experience to avoid a polarised property market.

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Background

It is important that policymakers understand the consequences of spatial change. For example, the well-documented decline of city centre High Streets as new out-of-town shopping malls drew away their trade. Similarly, the study was interested in understanding how the individual buildings and streets within central retailing areas, in and around the traditional High Street, have fared within the broader context of:

- Declining 'bricks and mortar' retailing; the current policy impetus on diversifying existing shopping areas; and the subsequent changes to the spatial distribution of retail and other property uses. Spatial changes have specific consequences for property owners because they affect the rent a property can command. This impacts upon the investment market in terms of property values and investment returns.
- The recent actions of property owners in managing decline, whereby retail restructuring has led to changes in the established practices and norms of the retail property market.

The study's aim was to identify connections between retail rents, use diversity, shifting market dynamics and adaptions in property market practices, to enable policymakers to better understand the interrelationship between urban retailing markets and resilience.

Research approach

The study was split into two stages. The first part examined the changing spatial distribution of retailing and other uses. It sought to open-up an evidence base for better understanding the spatial impacts of changing property uses over the study period of 2000-2017. This involved micro-level analysis of a new spatio-temporal dataset that was used with geospatial mapping technology to track patterns of property use in the central retailing areas of the five case study cities.

The second part of the study focused on changes in retail property market practices, especially in response to recent, significant falls in retail rental and capital values. It investigated changes in the established practices and norms of the retail real estate market. As such, it focused on owners, investors, and developers, given they are responsible for developing, adapting and managing properties. Primary data were generated through interviews with a sample of 27 property investors and practitioners involved in the five case study markets, with 'veteran' professionals targeted in order to capture their experience and opinions of change. Uniquely, the first interviews were conducted over the period January to March 2020, immediately prior to Covid-19 restrictions, and commenced again January to March 2021, as market activity was re-establishing. In this way, the study captured the beginning and subsequent acceleration of significant structural changes in the retail sector, including the balance of power in the market as it shifted towards tenants.

Findings

The study recognised the impact of changing property uses/ownership on both localised patterns of urban development and real estate practices. In relation to these two areas, the following provides a summary of the key findings.

Findings: stage one – spatial patterns

Shifting prime pitch boundaries

Retail areas are split into primary, secondary and tertiary pitches which are not fixed, but are based on investment quality and retail activity. For the study, given the prime pitch commands the highest market rents, changes in the location of clusters of properties that command the highest rateable values were examined, revealing the following:

- In three centres, sizeable retail-led redevelopments/initiatives had occurred (St Stephen's in Hull, Liverpool One in Liverpool, and Multrees Walk and George Street revisioning in Edinburgh). These schemes affected local preferences and behaviours in a variety of ways, which included shoppers being attracted by the novel-

ty value or better retail mix of the new development (pulling them away from their usual shops) or by enticing retailers to relocate into newer purpose-built spaces – or a combination of these effects. Consequently, the location of the prime pitch in these cities shifted towards these new developments, leading the centrality and shape of the prime pitch to be altered. This significantly and fundamentally changed each city centre and, as a result, the market rents achievable for the affected properties.

- In Glasgow and Nottingham, the centrality of the primary and secondary pitches had not shifted, but ongoing socio-economic and behavioural changes had resulted in store closures and changes in use, typically on the prime pitch's periphery, effectively contracting this area. These smaller shifts to the shape of the prime pitch were seen to 'creep' over time, be that in response to purposeful policy changes or more organic shifts in the fortunes of the market.
- As a general comment, the research was in accordance with the study of Crosby et al. (2005), whereby concurrent growth in consumer spending, an expanding retailing industry and a buoyancy of retailer occupation demand can mask spatial impacts. However, with the current and ongoing reduction of consumer spending in physical stores and the contraction of the retail sector, such spatial effects are becoming visible.

Other spatial findings (relating also to market rents)

- The pandemic exacerbated an already slowing retail market with high levels of uncertainty, characterised by the increasing use of Company Voluntary Agreements (CVAs), the collapse of large occupiers, and multiple branch retailers downsizing their portfolios and withdrawing from urban centres. The subsequent surge in vacancy rates caused a surplus of city centre retail space to emerge (and pushed retail market rents down).
- The most consistent pattern of change was the drop in the number of shops across all five case study centres and their subsequent conversion into food and beverage (F&B) outlets.
- The spread of F&B outlets suggests that, not only are centres diversifying, but F&B is now recognised as complementary to retailing. In the earlier years of the study period, owners were less willing to let units to these operators as F&B achieved lower rents than shops.
- Being located on a pedestrianised street had a positive influence on rents. However, it is important to note that the retail industry focuses on footfall (counting shoppers), which is not a metric that captures quality of experience.
- In the wake of the pandemic, vacated units were increasingly being let to independent occupiers who could not have afforded the previously higher rents.

Findings: stage two – market practices

The study found increasing complexity in managing retail assets, particularly in the areas of: (1) covenant strength perceptions; (2) flexibility in the leasing model; and (3) changes in rent pricing and property valuation practices.

Covenant strength perceptions

- 'Covenant strength' relates to the tenant's financial position. It represents the likelihood that a tenant will default on paying their rent. As such, the accurate pricing of covenants involves an assessment of risk. Market conditions mean traditional perceptions of a strong covenant no longer hold because so many (previously) strong covenant companies entered administration or CVAs. Consequently, the position of independent retailers has improved, whereas traditionally they were regarded as weaker covenants and less desirable tenants. While the shifts in covenant strength are complex, more open-minded owners no longer perceive independents to be such a high risk and, as a result, they are appearing in prime locations.
- There are difficulties in accurately pricing covenants as they rely on assessing the tenant's financial record. Independents, for example, may not yet have a track record to assess. This means that risk cannot be appropriately priced using current measures of covenant strength.

Flexibility of the leasing model

The area of greatest adaptation has been the leasing model. For UK owners, the historically predictable cashflow stream from commercial tenants has now become more volatile and complex. As such, owners are having to be increasingly flexible when negotiating leases with tenants, while also managing their own risk exposure.

Turnover rents

- Turnover-linked rents (a rent, in whole or part, calculated on a fixed percentage of the tenant's turnover) have been increasing and have become more popular as a result of the pandemic. While larger retailers started demanding this initially, the approach is now trickling down to smaller operators. It means that, if there is a poor trading year, the lease terms can effectively lower the retailer's exposure to fixed (rental) overheads and, thus, share the risks with the landlord. This can also make for a closer and more productive landlord/tenant relationship.
- However, the wider adoption of turnover rents has been met with unease from some UK owners due to their complexity, lack of transparency (it is not obvious how turnover percentages are negotiated or determined) and problems capturing a retailer's turnover – a figure that many have resisted sharing. As such, trust between parties in the negotiation has been difficult and has not been helped by the absence of a standard approach to measuring and setting appropriate provisions within turnover leases.
- The lack of a guaranteed rental level in a turnover lease pushes down the property value. Many investors are therefore uncomfortable with the unpredictability of income streams. As a result, the marked shift in favour of the tenant has become unsustainable for some owners who do not want to take on the levels of risk on offer. Also, when looking for finance, some investors find lenders are no longer will to lend on retail assets, or will increase the cost of borrowing to compensate for the higher perceived risks.

Leasing negotiations

- Retail assets need to be more actively managed to generate acceptable returns, but also require owners to be as flexible and accommodating as possible. Managing retail assets has become an increasingly complex affair, with owner and tenant negotiations and leases becoming ever more bespoke. Rent-free incentives to attract tenants were found to be commonplace, and rent-free periods longer. There were also shorter lease terms, while incentive packages included capital contributions and assistance with fit-outs to de-risk deals for tenants. In addition, there was a move towards total occupancy cost packages, where rent is inclusive of service charges, rates and possibly insurance, thus placing a greater onus on owners to tightly manage these costs. Furthermore, there were reduced repair and dilapidation obligations for tenants, and tenant-led breaks. Pandemic clauses were included in almost every lease, while clauses relating to CVAs were also emerging.
- There is nothing new in these leasing mechanisms. Incentivising deals usually take centre stage in negotiations when there is a market downturn and are squeezed out during a recovery. This raises questions about the permanency of recent changes as the market strengthens, although the greater use of turnover leases looks likely to remain in some sectors of the market, for example fashion retailing, where occupiers perceive these leases terms as more attractive than fixed rents.

Changes in rent pricing and property valuation practices

Property valuation is the process through which the value of an asset is estimated. Assessments of risk have become more complex, both in relation to covenant strength and the predictability of rental income levels. This has led to falls in value, but also questions over valuation methods.

- Even before the pandemic, ongoing structural changes had resulted in many retailers struggling with the affordability of shop space. As such, there were pressures for rents to be rebased downwards, which is now underway, particularly as the Covid-19 restrictions forced owners to adjust their expectations in terms of rental growth and accept decreases in asset values.
- With assets now priced at a different level, the fall in value for some shopping centres was described as almost beyond comprehension. Consequently, the viability threshold has lowered, and owners are more willing to repurpose their properties, moving towards more diverse uses. Occasionally, however, owners resist rental rebasing, awaiting the return of the halcyon days of retail investment. Consequently, vacancy levels for these owners are high.

- Retail property valuation processes are based on income security and expectations of rental growth and are struggling to handle the unusual cash flows associated with changing lease terms. While a particular issue with turnover rents, the conventional ‘all-risks yield’ metric, which underpins these processes, is also difficult to determine when faced with insufficient market evidence of increasingly complex risks. These difficulties were also highlighted in an independent review of valuation standards (Gray, 2021), which recommended that ‘growth explicit’ techniques[2] become the primary method in the preparation of valuations.

Recommendations

Changes in the management of properties and especially changes in property use ultimately affect both the private and public sectors. To encourage greater partnership working between stakeholders, promote desirable co-location of uses and support changes in real estate practice, the following recommendations for action are necessary:

Develop masterplans that treat a central retailing area as a single coherent entity with a clear vision. The masterplans would reflect the centre’s function, place identity and future economic and social opportunities. They would also identify areas for public investment and encourage greater partnership working to co-ordinate the public/private sectors in reimagining and integrating retailing streets. Additionally, they would include ways to measure/improve walkability (i.e. the ease by which pedestrians can move between two points) and amenity through the removal of impediments to pedestrian connectivity and streetscape enhancements. This would serve to improve the overall quality of experience within a central retailing area, extending the focus beyond retail footfall.

Devise initiatives to encourage greater use diversity. Such initiatives would add to ideas such as England’s 2020 Use Class Order revisions and Scotland’s Masterplan Consent Areas to find ways of promoting flexibility in the centre of cities. A more responsive regulatory system, as well flexibility within buildings, would help property uses adapt more quickly to market changes – with the caveat that monitoring is required to track unintended outcomes.

Introduce greater transparency in the property market. The property industry, which ultimately relies on information, is struggling with the lack of transparency of turnover deals. While owner/tenant relationships benefited from greater openness during the pandemic, this needs to be continued to ensure appropriate asset management and valuation practices are enabled. This includes the development of a standardised turnover methodology, but may also include the creation of industry benchmarks for different types of leases.

Improve data sharing around the financial position of tenants. Investors and valuers struggle to access reliable and up-to-date data to assess tenant covenants. Greater use of recent financial data sharing innovations would promote transparency between tenants and owners, enable investors and valuers to improve their assessment of tenant default risks and help landlords develop confidence in letting to independent tenants and newly established businesses.

Overhaul the valuation model and retrain professional valuers. Valuation practice needs to adapt to models that can encompass turnover rents and other lease changes. RICS, as the governing professional body, needs to take the lead by undertaking a systematic review of best practice, in order to establish a retail valuation model appropriate in the evolved market. This may require professional valuers to retrain, while education providers need to ensure graduates entering the profession are competent in the application of these revised methods.

Increase support for independent tenants. Independents, who are increasingly replacing multiple retailers, have individual needs and may have less experience in the property market. In terms of support, their needs may include help with more bespoke lease terms and more complicated clauses. This may help avoid a polarised market. As such, industry bodies, including owners, town centre associations and Chambers of Commerce, should provide additional support to help independent businesses become established and remain supported.

References

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Further reading

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Endnotes

[1] Real Estate, Place Adaptation and Innovation within an integrated Retailing System (REPAIR) supported by the Economic, Social and Research Council [grant number ES/R005117/1].

[2] These are contemporary valuation methods that build rental growth projections directly into the income streams that are capitalised when a property is valued, rather than rely on an all-risks yield to implicitly capture expected rental growth.