

CoStar Column: The Way Forward for Retail Assets and Landlord/Tenant Relationships

Charles Palmer, Senior Retail Advisor, Trimont Real Estate Advisors, Says the Future for Retail Real Estate Has to be Based on Trust



Retail is changing rapidly thanks to a range of factors including the pandemic. (Getty Images)

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Location, Location, Location. The three most important words in real estate have been temporarily replaced with Trust, Trust, Trust, particularly with landlord and tenant relationships in the retail sector.

Prior to the COVID 19 pandemic, high streets and shopping centres were struggling. This was partly due to systematic factors such as antiquated and tortuous planning/rating systems imposed

by statute. Additionally, the *Landlord and Tenant Act* proved to be incapable of meeting the needs of a modern market. What's more, with the internet being increasingly central to how the UK shops, a critical lack of ambition and foresight blinded many landlords and retailers to the changing nature of retailing. For retail to continue to be a viable and vital sector in the future, the landlord and tenant relationship needs to change.

Prior to 1954, tenants were poorly protected. The 1954 *L&T Act* helped retailers expand and build brands with the confidence that security-of-tenure would insure their investment. Landlords were able to lease properties for twenty-five years, giving them the confidence to invest in building new assets. This act helped shape the high street and create the shopping centre, by inadvertently triggering the gradual exodus of resident populations from the heart of town centres. Whilst not initially happy with the significant loss of control within their buildings, landlords saw the benefits and were able to continue building trust with their tenants. Relative calm had descended on the retail property sector. The last thirty years have seen the gradual erosion of the foundations of this relationship, causing problems.

The COVID pandemic has been very difficult for the sector. It has the potential to accelerate and hasten changes that may have otherwise taken five to ten years to achieve. The current situation is forcing both landlords and tenants to make changes that will make the sector stronger and more resilient for those who can survive, whilst enabling new brands to emerge in the coming years. A slower, more evolved change would likely not have been as effective.

Trust is key, and we have seen plenty of this from many landlords and tenants. Landlords who have been able to work with their tenants to grant deferred rent periods to help retailers open and "keep the lights on" will undoubtedly emerge strongest out of this period. Some landlords and tenants, because of their financial positions, have not been able to build the same bonds. Those relying on external funding and debt finance are having similar conversations with both their lenders and their tenants. The central word is still applicable – Trust.

On paper, this is all very theoretical and does not reflect the noise and carnage that is impacting the sector. The hard facts are that rent arrears for the sector are now set to exceed £3bn. Trust is not a word many in the sector are embracing right now. These rent arrears will need to be paid. Undoubtedly, there are some retailers that could pay and are instead playing the system. The CVA process, which has been abused by a small number of retailers for many years, is now being used as a threat by some. The new CVA has huge implications for landlords as retailers start assessing their lease obligations. Lord Wolfson, of Next, has recently observed that retailers, in many cases, took large cash payments to fit out their stores and stated that those same retailers need to show some responsibility. His is a minority voice. It is also clear that some landlords are not showing empathy or practical assistance to retailers where they can. Retail footfall is non-existent, and many tenants are either looking for a way out or simply ignoring their circumstances altogether. There is now a "wild west" attitude to the contractual obligations of a lease, and not much evidence of trust!

Where co-operation and trust are evident between parties, we are already seeing turnover leases being agreed upon. This is a foretaste of what is likely to come in the long term. The break clause, which has effectively created three and five-year leases over the last ten years, has also allowed landlords to exempt the lease from the security-of-tenure of the 1954 Act. Turnover leases, whilst causing valuers to rip up years of valuation practice in the short term, are being embraced by both landlord and tenant as a practical way to progress.

Neither party is happy as the landlord no longer has a guarantee to the income he is receiving, and the tenant must reveal far more of their trading figures than they ever had to. However, this collaboration and shared success/risk will make for a better relationship and help equip the shopping environment to meet retailer and consumer needs.

The landlord cannot merely build a scheme “and they will come.” They must make the shopping environment the best facility for retailers to maximise their turnover, which will benefit both parties. This involves maximising innovative technology, redesigning spaces, changing the tenant mix, and encouraging new brands. This goes for all brands, not just the brands with a strong covenant. Unfortunately, this has inadvertently made many town centres look identical throughout the UK.

It is this, not unreasonable pursuit of value (pensions and investments must provide returns), causing these centres to share the same names whilst slightly rearranging locations. This is much too sterile and cannot continue as centres can easily devolve into a sorry environment. We have seen this happen when “strong” covenants do not perform. The internet, with its choice, ease, and variety looks much more appealing.

Sharing information is essential for turnover figures, as is transparency. Some shopping centre leases with turnover provisions are already providing sales information to landlords in order to collect rents. The protocols will have to change to reflect full turnover leases. The usual issue of point-of-sale and internet sales/returns will need to be standardised as well. The small independent landlords outside of schemes and centres will endure the most change from their existing practices. I anticipate that the “traditional” lease with an annual rental that is subject to reviews will remain in these locations in the short to medium term. They are more practical for both parties and technology should provide a solution in time.

The retail market, and the players within it, have proven itself to be adaptable and flexible. Still, they have never had to react to such extreme events on top of major structural change in such a short period. Things will continue to be very difficult. There will be significant losses in value, assets, employment, and continuous impact on communities. Those who can emerge on the other side battered and bruised will help drive this sector forward. There is a future, but only for those who embrace it and, more importantly, for those who demonstrate trust.

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