

Landlords told to face a new reality on rents

The old leasing model is finished, warns Mike Ashley's property chief

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Sunday May 03 2020, 12.01am,
The Sunday Times



The finances of Hammerson, which owns the Bullring in Birmingham, are in tatters
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When Michael Murray flew to America's east coast five weeks ago, he was expecting to be home by now. Trapped by lockdowns on both sides of the Atlantic, the 30-year-old has instead been plunged into a disorientating routine, rising in the small hours to join crisis conference calls with fellow executives at Frasers Group (formerly Sports Direct International), where he oversees the property side of Mike Ashley's retail empire.

Despite the billionaire founder's characteristically brazen attempt to keep his 900 UK stores open, the vast majority have shut their doors, pushing some customers to buy online for the first time. That is far from the only change the sector will see, according to Murray. "It's obvious that people aren't going to go back to shopping in stores as much as they were pre-Covid, so there needs to be huge reform in how landlords operate," he said. "The old leasing model is finished. We need to move to a modern one based on turnover, which reflects the decline on the high street."

Ashley's future son-in-law - Murray is engaged to the tycoon's daughter, Anna - is calling for change in the knowledge that retail landlords are on the rack. After decades raking in solid income from leases up to 25 years long that stipulated rents could only go up, property owners are on shaky ground. Behavioural changes born out of the coronavirus lockdown, and the dire economic consequences of shuttering Britain's shops, mean years of decline will be condensed into months.

Carphone Warehouse, Laura Ashley, Cath Kidston, Oasis and Warehouse have shut their stores for good. Sir Philip Green's Arcadia Group has served notice to walk away from more than 100 shops, while John Lewis and Argos are set for closures. Murray expects Frasers to axe tens of stores as a result of the crisis.

Property experts fear the coronavirus will leave a grim legacy of derelict shopping centres and finish off high streets that were already struggling for life. "It will be an unholy mess and it will be very painful. This isn't like 2008 - we are not going to see a recovery in retail," said Joss Brushfield, who has established AK-ARM to manage distressed retail assets for landlords and banks.

The rise of online shopping and relentless cost pressures on retailers have shortened leases and driven down rents. Net effective rents - the average monthly payment over the term of a lease - slumped by a fifth last year, according to the estate agent Savills, which said this year's decline could be even steeper.

Turnover rents, where an agreed proportion fluctuates according to a store's sales, were already creeping into the market before the pandemic. With retailers expecting sales to be far below pre-crisis levels when they reopen, a clamour is building for wholesale change. "Turnover rents are the only way forward now. Landlords are going to have to get real on this or they will have more empty shops," said former Dragon's Den star Theo Paphitis, who owns the Ryman, Robert Dyas and Boux Avenue chains.

Frasers, which encompasses Sports Direct, House of Fraser and a clutch of smaller chains, reported pre-tax profits of £179.2m on sales of £3.7bn last year. The coronavirus crisis has sparked a 45% drop in its share price this year to £2.52, valuing the group at £1.3bn.

In an unusual arrangement, Frasers Group pays fees to MM Prop Consultancy, a separate company owned by Murray, according to an independent assessment of the value Murray's property deals create, judged to be £5.4m last year. Murray renegotiates more than 100 leases a year by serving notice on the landlord and demanding a turnover rent. If he cannot get one, the shop closes.

But while retailers yearn for more flexibility, landlords need to maintain stable cashflow to pay interest on debt and give returns to investors. That means they dislike turnover rents. "As a long-term property investor, I don't just want a share of someone else's business . . . if I wanted to be a retailer, I'd open a shop," said Matthew Oakeshott, chairman of commercial property investor Olim. "Accepting only a turnover rent is a sign of a desperate landlord."

There was desperation aplenty when Debenhams went into administration last month. The moribund chain managed to get landlords for 120 of its 142 department stores to agree a five-month rent-free period followed by new leases based on turnover. With no other takers for the cavernous retail units, they had little choice.

Lord (Simon) Wolfson, chief executive of Next, has said he expects to wring rent cuts averaging 40% out of landlords in 53 lease renewals this year. For turnover rents to become standard practice, retailers and landlords will have to become more open with each other - and put hostilities to one side. Retailers grew frustrated at being locked into long leases before angering landlords by jettisoning swathes of stores through company voluntary arrangements, a contentious form of insolvency, in recent years.

When many retailers refused to pay quarterly rent because of the lockdown, some landlords served statutory demands to force them to cough up, until the government stepped in to temporarily ban such action. Landlords have yet to receive any specific support.

Most institutional property owners back turnover rents in principle, but many are constrained from agreeing to them because doing so would provide evidence for another downward lurch in their property valuations. Structuring turnover rents is complex and subjective. Many landlords want online sales to be included. The researcher CACI says a retailer's online sales are typically more than twice as high within the local area, because customers can use click-and-collect and return items easily - but apportioning that value to a rent is fraught with difficulty.

Quantifying the value of shops operated by brands such as Microsoft and Nespresso - whose stores are as much showrooms as they are places to sell goods - will be especially difficult. A property veteran said: "I can't trust retailers to give me the right turnover figures. They'll fudge it. Turnover rents are not the panacea, they're another factor."

But landlords have strong incentives to work things out. After the financial crisis, shopping centre owners papered over the cracks by replacing fallen retailers with restaurants and cafes - increasing their exposure to the current crisis. This time round there are no such quick fixes. The finances of Intu, which owns Manchester's Trafford Centre, and, to a lesser extent, its rival Hammerson, which owns the Bullring in Birmingham, are in tatters, making any meaningful repurposing of sites look impossible.

With its shares priced at just 6p, Intu is valued at £82m, compared with the £8.4bn book value of its assets. The huge discrepancy is principally down to its £4.7bn debt pile. Hammerson's shares have crashed by 79% to 65p this year, valuing the company at £498m - an 89% discount to its £4.6bn net asset value.

One institutional landlord said many shopping centres would see their occupancy levels collapse to an unsustainable level. The prime candidates are "secondary" centres owned by private equity firms that have loaded them with debt. "Rents have already halved in our centres and now they are heading to rock bottom," said one private equity investor, who is in crisis talks with his banks over two shopping centres.

The coronavirus threatens to hollow out some of Britain's long-suffering high streets, too. There are signs, though, that consumers have been reconnecting with independent local shops. Queues outside neighbourhood butchers, bakers and grocers have become common during the lockdown, as shoppers seek to minimise trips to supermarkets.

Bill Hughes, head of real assets at Legal & General Investment Management, believes the crisis could act as a catalyst for the government to empower local councils to use compulsory purchase orders, which would cut through the fragmented property ownership that has held back regeneration projects. Planning laws inhibiting change of use could be relaxed, and retail rents would crash to levels where the economics of repurposing stores finally stacked up.

"This is a slash-and-burn environment," said Bill Grimsey, a campaigner for high street regeneration. "We will see the old guard in retail cleared out and entrepreneurs rising from the ashes."

It can only be hoped that he is right, and that survivors and property owners can agree on a new future. The scale of the crisis means tenants and landlords alike are facing a Darwinian moment.

Source: <https://www.thetimes.co.uk/article/landlords-told-to-face-a-new-reality-on-rents-3zqc0csph>