WHAT IS YOUR SHOPPING CENTRE WORTH?

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Synopsis

In today's market, the impact of the Covid restrictions has accelerated trends that were already occurring. What was likely to take two or three years to come to fruition has been crystallised overnight. Retailing is going through a structural change and asset values are tumbling as the effect of falling rents and a lack of investment appetite feeds through to the market value of the properties. But, these headline changes are hiding other significant evolutions in the income potential of physical centres.

Good management means that shopping centre owners need to transform their investments into retail destinations to unlock the potential of customer data and brand cash flows.

Unlike a shopping centre, which is primarily a place for customers to shop, a retail destination provides visitors with a range of unique and memorable experiences, including shopping, entertainment, eating, leisure, and cultural activities.

What a property is worth to the owner is different to the current market price as determined by the property valuer. This paper looks at the distinction between worth and value and how understanding that distinction can work to the benefit of all stakeholders and will, hopefully, lead to a change in the way in which shopping centres are valued.

Introduction

With footfall and sales down, how do you justify your property's pre-Covid-19 valuation? The conventional rent-based method of valuation, used by all UK property valuers, only looks at the actual and estimated cash flows generated by the occupation of individual shop units. Some of these leases will be 100% rental, others will be a mix between a core rent and a share of turnover but most of them are based on the comparable rents of similar units in the same centre.

The value of a shopping centre is, conventionally, total rents multiplied by a market multiplier either as a cash flow analysis or a simple capitalisation model.

These valuation models fail to capture the additional cash flows that can be generated through brand awareness, data targeting and customer loyalty programs - all of which should form a part of your internal assessment of the worth of your shopping centre.

The "worth" of an asset is an individual assessment of the benefits and liabilities of ownership, the "value" is an estimate of the price in the market. These figures can diverge according to market conditions, as is happening with the Covid impact, but they can also diverge when the valuation model fails to capture the same drivers as the worth calculation. This aspect needs to be addressed.

Fortunately, there is growing momentum within the industry to lobby property valuers to recognise the new drivers of business value in your organisation and reflect these within the estimate of market value.

Read this thought-provoking paper on how to reflect new cash flows in the worth of your retail real estate portfolio while also strengthening your organisation's capability to generate revenue from the one stakeholder that matters most - customers. You will also learn:

> - The important difference between the worth and market value of your centres
> - Why shopping centres that have transformed into retail destinations are worth more
> - How to lobby valuers to understand the increase in cash flows and thus reflect this with an increase in value

Property Valuation Models

Ideally, the rent of a shop unit should be a reflection of the worth of that space to a specific retailer and, thus, the value of a shopping centre as a whole will be the capitalisation of total rents at an appropriate discount rate/yield. This may be by a discounted cash flow model or, for simple analysis, based on a single multiplier called the all-risk yield. This is a rate that reflects the attractiveness of the asset to investors in the market. When there is substantial demand for shopping centres, this capital multiplier (which is the inverse of the yield) will be high but when investors are less enthused by the potential cash flows that will flow from ownership, this multiplier will be less (and the yield will be higher). This valuation method is called the Investment Method.

The market value of a shopping centre, which remember is an estimate of the price that an investor would pay for the shopping centre at any point in time, isn't just determined by the cash flow created. Price in the market is influenced by the number of potential buyers in the market. The more demand then, all other things being equal, the higher the expected price. Price also reflects potential.

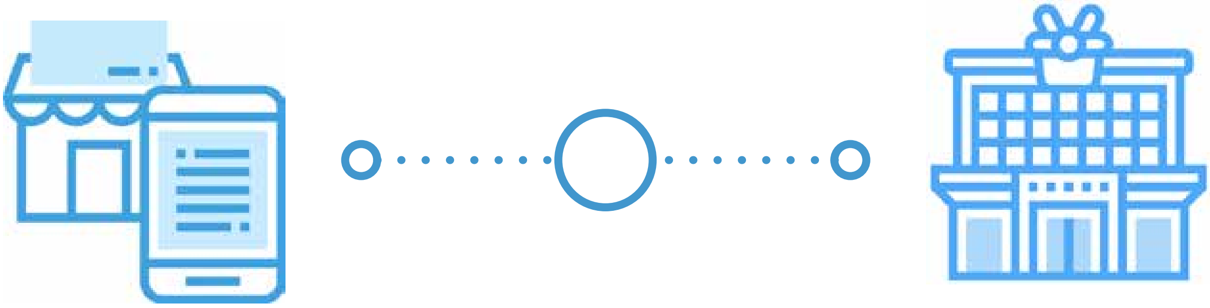
For example, a shopping centre might be run poorly by the current owner but incoming buyers can see that it has the potential for a greater cash flow in the future if run more efficiently. Market Value or Price will capture this as well. So the way in which the shopping centre is leased and the types of leases offered all will affect rents and capital value. Market Value is influenced by the way in which the business is run, the way in which the building is maintained and managed and the synergy between the owner and the retailers.

But retailing is changing. In the UK, pre-Covid, 20% of retail sales are now online but research[1] shows that, of these sales, 30% are also related to physical stores (i.e. a consumer looks at options in the shops and then orders online). So given that the rent paid for physical space is, historically, a reflection of what the space is worth to a retailer, how does this fact impact upon rents? There are sales (online) that won't be captured by a store's turnover. The principal question is whether valuers are capturing all these changes in their valuations?

[1] "Tomorrow's World: Retail on the line". REVO, 2018

The answer is probably not in the short term and only in the long term if owners, tenants and valuers start working more closely together to share information. In fact, it could be the opposite as some companies sign "net turnover" agreements which means that unwanted online sales are returned to the store and deducted from the stores turnover as a refund thus reducing the turnover rent. The relationship and interplay between online and physical sales needs to be made more open.

> "The old relationship (between landlord and tenant) was quite adversarial. That's not going to work anymore. Everyone is going to have to take the pain, and it's always best to share it."
>
> Richard Hyman, Retail analyst [2]



In terms of investment, yields have moved out to reflect the uncertainty in the market and the erosion of retailers' covenant strength in the current market but are the rents being agreed capturing the impact of online sales, data collection and brand awareness? The shop window is now much bigger than the physical footprint of the shop so how does the valuer know the real worth of the space occupied? And, in fairness to valuer, often the benefits and details of the new revenue opportunities are not being made available to the valuer; they can't value cash flows that are unknown to them.

This explains why valuers are reluctant to change their rent-only based valuation models. But, these cash flows are being captured internally by many proactive and innovative owners. These are the owners who understand that the physical asset is intrinsically linked with the overall retail business and have transformed their shopping centres into retail destinations which capture and enhance these new avenues of income.

[2] BBC News, Shopping centre giant Intu on brink of administration, 26 June 2020

The Worth of a Retail Destination

Speaking about the recent financial failure of shopping centre owner Intu, the chief executive of data provider Retail Economics said:

> “While the collapse (of Intu) has been highly anticipated, its significance cannot be understated. Many retail landlords remain stuck in an age of analogue retailing, sluggish to adapt their business model to the inevitable impact of online and evolution in consumer behaviour.”
>
> Richard Lim, CED Retail Economics [3]

This is the central tenet of this briefing, the need for owners to embrace the role of digital retailing and work with tenants to exploit and expand the benefits of data capture for the benefit of both parties; brand awareness opportunities and customer loyalty schemes.

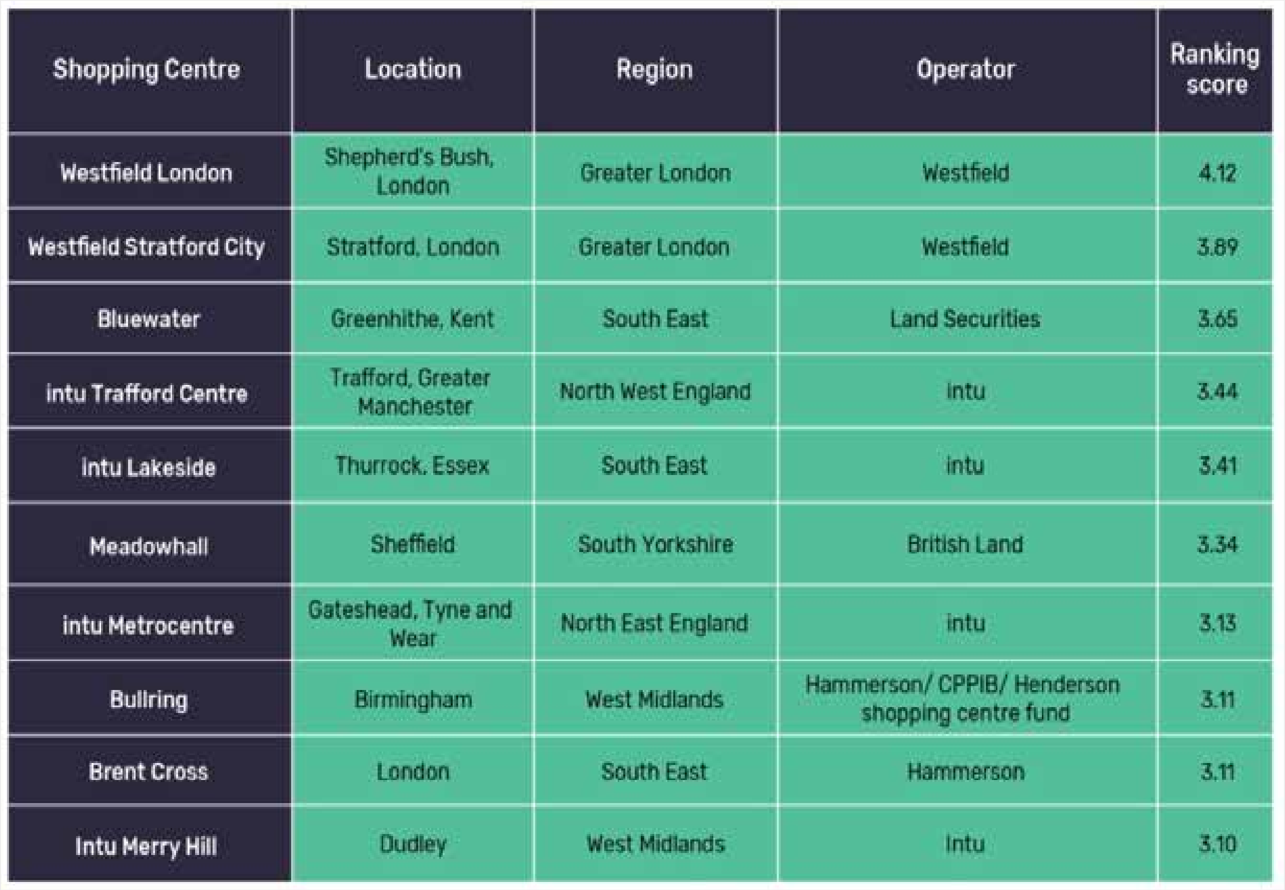
At the moment we are, at best, at a crossroads for the structural change in retailing and specifically for shopping centres or, at worst, we are, with Covid-19, experiencing a perfect storm. There is so much noise in the market at the moment, with retailer failures and Covid-19 rental retention, that it would be easy to lose sight of changes that are happening and the opportunities that are arriving. Whilst the loss of any retailer is sobering, it should be remembered that the majority of retailers and restaurants that have gone into receivership are ones that were already struggling pre-Covid. The impact of the pandemic has just accelerated the natural selection of the retail environment. Good adaptive and innovative retailers survive. And shopping centres will survive if they adapt accordingly.

Shopping centres need to become retail destinations to benefit from the new digital economy and its interface with the physical shop front. They need to augment the traditional cash flow of rental whether in the form of a base rent and/or turnover (tempered by more flexible lease terms and lease lengths) with the new cash flows created by brand management, data collection and targeted marketing - and a mix of the three through customer loyalty programs, which is a proven driver of value creation.

[3] Thisismoney.co.uk, Shopping centre giant collapses: Demise of Intu, 26th June 2020

Many retail destinations are already doing this and reaping the benefits of new and expanded cash flows. This is reflected in their internal assessment of worth but, sadly, has yet to be transferred to valuation models. So, the question is, how do you show the true business value of your property? And where is the divide between the "business valuation" and the "property valuation." To answer these questions, it may be the time to stop viewing shopping centres as investments based purely on rental cash flows and to start viewing the value of the asset as a subset of the business' profit.

It is worth pointing out that research conducted by GlobalData last year, which published its list of the top UK best performing shopping centres.



Shopping Centre	Location	Region	Operator	Ranking score
Westfield London	Shepherd's Bush, London	Greater London	Westfield	4.12
Westfield Stratford City	Stratford, London	Greater London	Westfield	3.89
Bluewater	Greenhithe, Kent	South East	Land Securities	3.65
intu Trafford Centre	Trafford, Greater Manchester	North West England	intu	3.44
intu Lakeside	Thurrock, Essex	South East	intu	3.41
Meadowhall	Sheffield	South Yorkshire	British Land	3.34
intu Metrocentre	Gateshead, Tyne and Wear	North East England	intu	3.13
Bullring	Birmingham	West Midlands	Hammerson/ CPPIB/ Henderson shopping centre fund	3.11
Brent Cross	London	South East	Hammerson	3.11
Intu Merry Hill	Dudley	West Midlands	Intu	3.10

To determine its ranking, GlobalData used traditional metrics such as turnover and footfall, as well as taking into consideration future potential, provision of retail, food service and leisure facilities and, uniquely, the views of the shoppers who have visited them.

The interplay between Worth and Value

The worth of a retail destination is being enhanced by new cash flow streams apart from the rental. It is similar to the distinctions in the hotel market between basic hotels that only offer accommodation and spa or sport hotels that offer a whole range of additional cash generating benefits such as gyms, sports facilities, swimming pools and ancillary bars and restaurants. Property valuers were quickly able to capture these additional benefits as the model used for valuing such assets (the Profits Method) looked at all cash flows such that the worth of the asset to the operator was reflected in the rent (real or hypothetical) that they could pay for the hotel. This is not the model used for valuing shopping centres.

The Profits Method is used where the business carried out in the property is intrinsically linked to the property itself. Examples of such property types, in addition to hotels, would be restaurants, pubs, bars, leisure centres and any building where the cash flows are generated due to the nature of the activity carried out in the property. It can easily be argued that the structural change in retailing and the explosion in digital income opportunities means that shopping centres and retail destinations are the same. A business and a property intrinsically linked.

Internal worth models are already doing this (they are effectively cash flow profit models) but due to the history of shopping centres as rent generating assets, property valuation models are still based on the investment method and not the profits method. To change this mis-match, property owners need to lobby valuers so that they can both understand the increase in cash flows and reflect the same in the market value of the property. Until this happens, much of the real business value in retail destinations isn’t captured in the valuation of the property asset.

And to a certain extent, there’s the rub. One of the reasons that there is an inertia in changing the valuation model to better mimic the worth analysis is that the current valuation model works with the information currently available to the valuer. To instigate a change, for the benefit of all the stakeholders in the market, the players involved need to work more closely together so that the cash flows that aren’t currently being captured by the valuation are made available to the valuer. Only in this way, will the “lost worth” as noted above be reflected in the valuation.

Liaising with Stakeholders

Sadly, valuation models will not change overnight; it will require a concentrated effort by all stakeholders to implement it. Normally, change takes years but, ironically, the impact of Covid-19 measures have given us a “window of opportunity”. Valuers are struggling to determine property values at the moment as there is so much uncertainty in the marketplace. Even within the existing investment method, there are unknown cash flows.

With shops shut, many landlords have tried to accommodate their tenants with rent holidays or a change away from the normal quarter day rental payments to monthly in advance in an attempt to ease the cash flow crisis being faced by many retailers. Valuers have reflected this by building in three month or six month voids in the total cash flow to reflect the reality of just 13.8%[4] of rents being collected from retailers by landlords in June.

But, equally with no occupational transactions or investment sales in 2020, it is difficult to determine market rents and market yields. So valuers are looking to all stakeholders to help with assessments of market value. This is an opportunity to lobby for a change in valuation model so that Market Value is reunited with worth.

All UK valuers are members of the Royal Institution of Chartered Surveyors (RICS) and they make recommendations on best practice. Again, now is the time to lobby the professional body. Articles and discussions by all stakeholders, including valuers themselves, can only lead to a better understanding and a quicker transition to a more appropriate valuation model.

Even with the acceleration caused by Covid-19, this will not happen overnight. Many owners are struggling with debt and, more specifically, their bank’s view on debt risk. Obtusely, one of the principal metrics for assessing the banks exposure is the loan to value ratio (LTV). The relationship of the debt to the current market value. Intuitively, this seems to be a reasonable heuristic but it is a snapshot in time and doesn’t look at the ability of the mortgagee to service the loan.

[4] BBC News, Shopping centre giant Intu on brink of administration, 26 June 2020

The market value is an estimate of price in the market yet during downturns, this is naturally less certain. It is also a number that will change with time. An investment with no variation in income can move from (say) a 50% LTV to a (say) 70% level without any change in trading whatsoever simply due to the demand for shopping centres falling and the yield changing from (say) 5% to 7%. This may appear to be a substantial change but, from talking to valuers in the market, it isn't impossible as the retail market goes through such structural change.

The point is that banks tend not to entertain LTV ratios of greater than 50% and many of the debt covenants will stipulate such a requirement. Intu had a LTV of 67.8% before entering administration[5]. But, that said, the LTV ratio is a very blunt instrument of risk assessment. Banks, historically, don't understand the distinction between value and worth.

And what about the continuing impact of Covid-19, a lot of the current forecasts are suggesting that the financial markets will continue to bounce back buoyed by the fiscal and monetary policies of governments around the world that have acted like a sugar-kick to the recessionary malaise. Most forecasters see a deep short sharp recession returning to January 2020 levels of consumer activity and financial trading in early 2021.

But, remember that Covid-19 has already accelerated existing trends to levels associated with structural change and this has created an opportunity to change the way in which the industry works and prices assets.

[5] S&P Global, Intu collapse offers cautionary tale for landlords dicing with debt, 2 July 2020

Checklist

So what can be done in the short term and long term to fairly reflect the structural changes, good and bad, in the retail market and specifically with shopping centres

1 Develop a strategy to transform your shopping centre to a retail destination to access and expand business cash flows generated by the property, leveraging customer data and loyalty programs to increase customer engagement and revenue generation.

2 Talk to your lender and explain the distinction between worth and value and the snapshot in time nature of market values. Explain the "lost worth"

3 Talk to your lender and discuss the uncertainty currently attached to property valuations and the likelihood of a sharp bounce back in 2021

4 Lobby valuers to consist a new valuation model (Profits Method) for the valuation of shopping centres/destination shopping and consider sharing the requisite information with them

5 Lobby the RICS to take a lead in ensuring that the right valuation model is used for the valuation of shopping centres/destination shopping

Conclusion

This is a difficult and tumultuous time in the market. Covid-19 has accelerated changes that were already taking place albeit at a slower pace. As the retail analyst, Richard Hyman, stated,

> "In many ways, the pandemic is an accelerator, and will really have forced change that would have taken five years or more to happen now."
>
> Richard Hyman, Retail Analyst [6]

[6] BBC News, Shopping centre giant Intu on brink of administration, 26 June 2020

But, as with all periods of significant change, there are opportunities as well as threats. It isn't possible to swim against the market but it is possible with good planning and good support to navigate the rapids to calmer waters. Valuation models will change but that will not happen overnight.

All stakeholders need to work together to manage such change but now is not the time to wait for the industry to change without your involvement. All owners have the gift to drive change within their own business and to release new avenues of income. In the short term, these opportunities might be hidden or difficult to access in the mid-Covid environment but it does provide a window to put in place systems that will transform your shopping centres into retail destinations. This will add to the worth of the asset and, in time and with appropriate lobbying, eventually valuers will reflect this in their valuations.

About Coniq

Coniq is the Total Customer Engagement Company for growth minded retail destinations. Its award-winning SaaS platform, IQ, is used by organisations seeking a faster, cheaper and simpler way to win and grow customers.

The IQ platform provides clients with the tools and data to understand, anticipate and engage shoppers in real-time across physical and digital touchpoints. The business value is quick, helping shopping centres to accelerate customer acquisition, delivering an average increase in sales per customer by 32%.

Coniq operates in 24 countries, providing customer engagement and loyalty programs for hundreds of shopping centres and more than 1,800 retail brands in 5,000 locations. Coniq's clients, operating around the world, include Apsys, Compagnie de Phalsbourg, The Bicester Village Shopping Collect, LIWA Trading Enterprises, VIA Outlets, Starbucks.

To learn how retail destinations are innovating, visit www.coniq.com.

About Nick French

Nick is a recognised expert in the area of property valuation and appraisal. Previously, he has worked as a professor at various Universities in the UK, Europe and the USA teaching extensively in the areas of valuation, investment and corporate real estate on BSc, MSc and MBA programmes.

Currently, he is working closely with The European Group of Valuation Associations (TEGoVA), is a member of the Royal Institution of Chartered Surveyors (RICS) and has regularly served on the various committees such as the UK Valuation Board and the Corporate Real Estate Strategy Group.