Israel IVS Forum

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International Views and Approaches

The Valuation of Shopping Centres

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We have asked Christian Luft, an expert on shopping centre valuations, to write a short introduction on the subject, with an emphasis on recent trends and on his thoughts as to future developments. The intention is that this short paper act as a preliminary acquaintance with international best practice in the field, for the benefit of Israeli valuers and the global real estate valuation community at large. **- Israel IVS Forum**

ABOUT THE AUTHOR

Christian is EMEA Head of Retail, Valuation Advisory at JLL, having previously led the Pan EMEA Valuation business from September 2018 to July 2020. Christian is also a member of the IVSC Europe Board.

Christian worked as a specialist retail and shopping centre valuer for twenty years, focusing initially on UK shopping centres before moving across to the Pan European business to focus on growing the retail valuation capability and track record across EMEA. Christian led the expanded UK & EMEA Retail Valuation team from September 2013 until September 2018.

INTRODUCTION

The evolution of shopping centres is accelerating at a faster pace than at any time since their inception. The approach to the valuation of this asset class is also having to adapt to reflect the realities of the retail sector and the intensive management of shopping centres in the current climate.

Previously shopping centres were considered highly desirable assets by institutional investors. They offered diversification of income in a flourishing sector with strong rental growth. Allied to this was the opportunity to deploy significant capital in a single transaction rather than in multiple deals.

Once acquired, the focus was on growing income and rental values, secured against relatively long leases (compared to other asset classes) with strong covenants.

LEASE STRUCTURES

Lease structures differed between the United Kingdom and continental Europe, which impacted on how these assets were valued. In the UK leases were typically ten years or more in duration, with upward only rent reviews every five years. This led to a direct capitalisation approach where income streams were valued with a hardcore/layer or term & reversion method of valuation.

In continental Europe leases are typically shorter in duration and there are no rent reviews, but instead there is indexation. This led to DCF methodology being the more favoured approach.

In many European markets leases based upon a base rent plus a turnover top-up rent have been established for a long time. The use of a DCF to value these income streams is considered more appropriate, especially when modelling growth in sales and base rent that may have different growth rates, thus impacting on the element of turnover rent being demanded over the duration of the lease.

In the UK base plus turnover top up rents were introduced later and typically as a less favoured option, used more with underperforming shopping centres and as a way of trying to protect the headline rent when a new letting would otherwise be agreed at a lower rate per square foot. It has only become more commonplace quite recently as rental levels have become unsustainable and retailers and other operators sought a way to arrive at an equitable solution. With the increase in online retail this was also a way to direct sales

online and reduce the turnover rent payable under the terms of the lease, which is a more attractive proposition to tenants than to landlords.

Coupled with the increase in base plus turnover top up leases, the average lease duration has fallen with more and more leases agreed outside of security of tenure legislation, giving the landlord more ability to rotate tenants or remove tenants and introduce new ones. With this increased management intensity comes a greater requirement to scrutinise and forecast cashflows. It also requires more sector expertise in management.

THE CASE FOR DCF METHODOLOGY

This has resulted in the greater need for the approach to valuation of shopping centres to become more aligned in the UK with continental Europe. Covid-19 has accelerated this need further as online sales have accelerated at a time when there is increasing uncertainty around the security of contractual income. A direct capitalisation approach is therefore becoming unfit for purpose in this sector. Shopping centres are in effect run as specialist businesses and the mindset is to value these in the same manner as a Going Concern.

The current structural changes in the retail sector are not just linked to online retailing but to the whole symbiotic relationship between the consumer, the retailer and the landlord. Consumer behaviour has shifted dramatically, partly due to rapid advances in technology. The consumer displays less loyalty towards most brands, is more price sensitive and is more concerned about other aspects of the retailer itself such as sustainability, ethics and social governance. The consumer demands experience from shopping as well as a leisure pursuit, which shifts the operation of a shopping centre from one of maximising short term gains to longer term longevity and resilience. Again, a static model of valuation struggles to provide the flexibility and adaptability needed in valuation methodology, and a DCF method is better suited.

RENTAL VALUES

As there is increasing uncertainty around the sustainability of retail rental levels, especially whilst we start to witness the economic impact of the Pandemic, there is a greater focus on the future sustainable levels of rent rather than what is technically secured today by lease contract. Investors want to look at the robustness of the retailers, understand their operating models, get comfort at the appropriate rental levels, and only then consider yield. With more flexible leases including at least an element of turnover rent, there is also the

need for more transparency on sales data disclosed by tenants. This way the valuer can then also consider appropriate occupational cost ratios (OCRs), which in itself is made more complicated by how online sales are dealt with when items are collected or returned in-store. Additionally, the basis of sales levels in a post-Pandemic world is currently an unknown factor and should only be based upon pre-Pandemic levels with caution.

DISCOUNT RATES AND EXIT YIELDS

Adopting DCF methodology enables the valuer to reflect the systemic risks in retail and the perceived risks in the cashflow through the choice of discount rate. This can be adjusted to reflect many risks to the cashflow, such as competition, or if the current rental levels are considered unsustainable. The discount rate can be considered therefore unlinked to the exit yield. A higher gap between the discount rate and the exit yield can therefore reflect a higher degree of risk considered in the cashflow, which may vary asset by asset even if the exit capitalisation rates based upon market evidence and sentiment may suggest a similar yield to be appropriate.

The exit capitalisation rate remains a market derived (evidence or sentiment) yield that should mirror the anticipated shopping centre at the end of the cashflow period (10 years in more mature markets, typically 5 years in more opaque markets) but at today's market conditions. The initial yield and running yield act as a sense check as to the rental returns in the short term, and measured against any investment comparable evidence that is usually expressed with an initial yield as the published yield.

SUMMARY

DCF methodology therefore provides the valuer with a greater ability to use their judgement in what is becoming a highly complicated sector in which to value, and with dwindling investment volumes to gauge the market. It is clear that ownership of shopping centres is a specialist business. As a valuer is to reflect the investment market at the valuation date, it is vital that the valuer too is a specialist who understands the sector and can apply specialist knowledge and understanding to the valuation.

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