



FSP RETAIL - SUSTAINABLE RENT

WHITE PAPER

May 2007

FSP RETAIL - SUSTAINABLE RENT

WHITE PAPER

The Issues for Retailers

Successful retailing is about more than selling merchandise. It requires business skills that do not come naturally to all retailers. The principal weaknesses seem to be:

- Optimism - a tendency to over-estimate the achievable sales
- Financial ignorance – typically in failing to provide for depreciation

When actual sales fall short of budget, the lack of allowance for the depreciation of fixtures and fittings soon shows, retail outlet looks tired and store performance is adversely affected. It suffers from its lack of investment.

The Issues for Owners and Managers of Retail Property

To regard the above issues as affecting only the retailer is a mistake: impacts felt here will soon impinge on the property owner:

- tenants who cannot pay rent will need to be replaced
- rundown stores with little investment will detract from the Centre's overall offering

There is a real need to identify which retailers are struggling in the present, and have advance warning of those which are likely to face problems in the future. Such information will allow the Centre owner to examine the options and take appropriate action before the situation becomes critical.

Sustainable Rental Income Analysis

The retailer's target rate of return is in direct proportion to his investment in the trading assets, i.e. the cost of stock plus fixtures and fittings in the store. Not all retailers are aware of the need to calculate this rate of return and meet it through sales. FSP has used many years of data to establish that the long term minimum rate of return on trading assets (ROTA) must not fall below 25% if longevity of the business is to be assured. This means that the annual net profit from the store should be 25% of the capital invested. Some retailers choose to express this as a 4-year pay-back period.

Retailers which have a history of achieving a ROTA in excess of 25% will be understandably reluctant to take on a new store where projections show the return to be less than its company average. One of the most negotiable aspects in determining the ROTA of a business is rental costs, which can be regarded as a dependent variable in the retail store equation. A rent cost that prevents the retailer achieving a ROTA of 25% (or the company's average, whichever is higher) is thus determined as being excessive for that particular retailer.

It is therefore important to determine the sustainable rent for each retailer in the Centre. FSP's analysis techniques allow a comparison to be carried out between sustainable and passing rents. The analysis will show the vulnerable retailers, whose passing rent is substantially in excess of that which they can sustain; it will also reveal retailers with sustainable rents that exceed the passing rent. This analysis, when used in conjunction with FSP's database of retailer performance, will identify the key reasons for the retailer's performance, whether that be due to poor use of space, over-trading, or poor sales density.

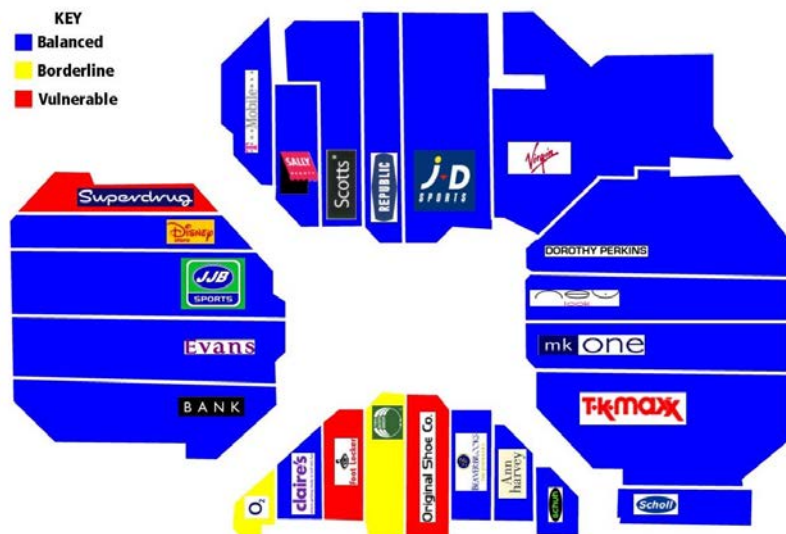
Management Intervention

Rental affordability analysis is a basis for asset management initiatives such as re-siting the store or replacement of failing retailers, and can be a platform from which to devise an informed rent review strategy by prioritising those retailers which have a high degree of rent affordability.

At the heart of rent affordability analysis is a retail audit that measures the allocated space in each store and estimates the sales achieved. FSP can demonstrate accuracy to within 5% of the true figure with such estimates. Basing their figures on achieved sales, FSP draws up a Profit and Loss Account for each retail outlet and estimates the rent which the retailer can afford to pay allowing for a ROTA of 25% or the retailer's average, whichever is higher. This comparison of sustainable rent against passing rent will highlight any retailers that are at risk within their current stores. Retailers with sustainable rent more than 25% below the passing rent are considered borderline and those with sustainable rent more than 35% below passing rent are considered vulnerable.

Outcomes and Examples

The following plan shows a Shopping Centre where rental income analysis had highlighted those retailers that would benefit from management intervention. Examples follow:



Original Shoe Company

In this case the space conversion was good and sales density was only slightly below the retailer average. However, the rent per square foot was almost double the Original Shoe Company average, and an imminent rent review threatened to further increase the Company's vulnerability. These factors were brought to light by FSP research, allowing management to offer the retailer a less prime site whilst retaining its presence within the Centre.

Footlocker

This retailer was generating insufficient sales in the unit it was occupying. Meetings with Centre management allowed the retailer to discuss its current performance and look for ways to gain assistance with marketing and promotion without relocating.

New Look

This was an undersized unit compared with recent New Look stores, and as a consequence the sustainable rent was well in excess of the passing rent. This information allowed the Centre management to investigate opportunities for the retailer to upsize. As a result existing units were reconfigured to enable New Look to relocate to larger premises.

Body Shop

Poor space conversion had led to this retailer paying a high rent for unused space. The outcome was for management to offer a smaller unit, to which the retailer relocated.

Conclusion

Success in the retail environment relies on business skills and analytical techniques that empower management in their decision-making enable them to regain control and allow them to identify problems before they have an adverse effect on the overall performance of the Centre. Managers must be aware of vulnerable tenants who are likely either to collapse or need to move out, as well as tenants that are over-trading. The information used as a basis for such decisions must be accurate, timely and presented in a manner that will be accessible to both Centre management and tenant.

FSP analyse these factors in detail based on years of research and using proven techniques. This analysis facilitates open negotiation between management and tenant towards a 'win win' outcome.



**FSP RETAIL BUSINESS
CONSULTANTS**

20 Manor Court Yard
Hughenden Avenue
High Wycombe
UK, HP13 5RE

T +44(0)1494 474740
F +44(0)1494 474262
admin@fspretail.co.uk

www.fspretail.co.uk
www.snap-shop.co.uk