



Product Focus from FSP's monthly newsletter Retail Pulse

Sustainable Investment – Trading Risk

Product Focus from FSP's monthly newsletter Retail Pulse

Sustainable Investment – Trading Risk

With schemes in the hands of administrators, debt driven 'fire sales', the high cost of filling voids, continuing deterioration in the financial health of occupiers and worries about the future of the UK economy, beleaguered investors can be forgiven for feeling unenthusiastic about retail property.

Given the right knowledge however, it is still very possible to acquire assets with growth potential and to create conditions which will stimulate sustainable income growth. This Product Focus is the second in a series of three, covering Corporate Risk, Trading Risk and Income Growth. The series is intended to illustrate how appropriate pre acquisition research and good asset management can have a positive influence on income growth and potential exit yields.

If Corporate Risk is the risk to specific shops which arises through the overall financial performance of the retail chain, Trading Risk (sometimes known as Unit Risk) is the risk which arises through the performance of individual outlets within a specific asset. This most commonly occurs where the trading performance of a particular store is such that the level of rent which can be sustained by its turnover is less than the passing rent on the unit.

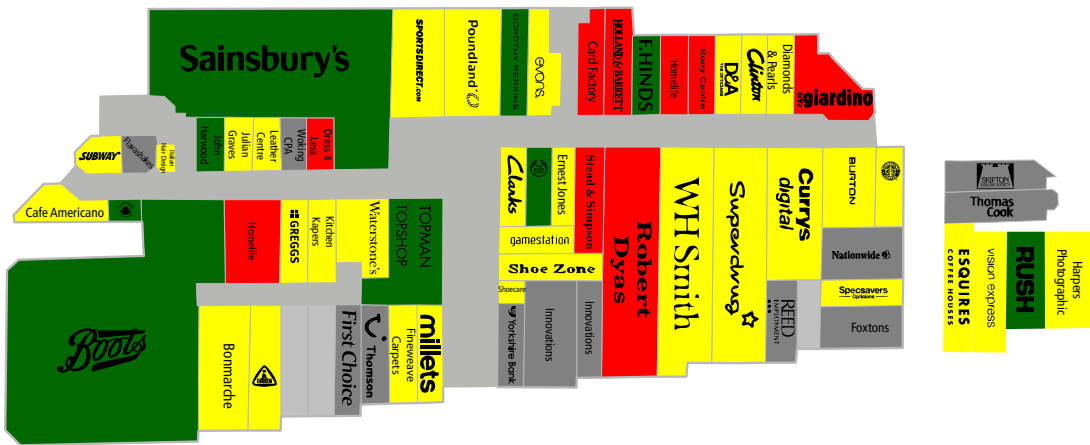
While some healthy multiples may be able to support this situation for a number of years (either in the hope that the situation improves or because it is important to maintain market presence), Trading Risk becomes particularly important when Corporate Risk is high. The spate of pre pack administrations between 2008 and 2010 saw huge numbers of unprofitable stores closed, with towns such as Blackpool, Coventry and Bradford becoming top targets for the accountant's axe.

Whilst these closures may have felt inevitable, it is possible for asset managers to understand the specific trading risk within assets and minimise potential for store closures by taking steps to ensure that sustainable rents are on balance higher than passing rents. For potential investors, knowing the scale of trading risk and understanding how much growth is required to improve turnover to sustainable levels should be an essential element of pre-acquisition due diligence.

Understanding Trading Risk

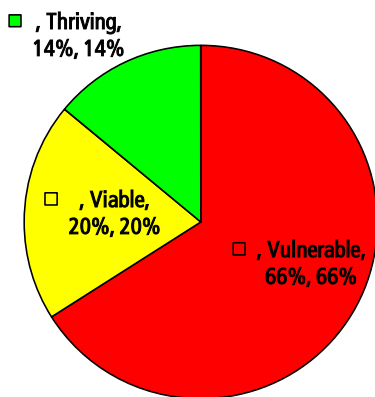


The key to understanding Trading Risk at an asset is understanding turnover. A small number of locations collect occupier turnover statistics however, for those less information rich, the most common approach is to undertake an audit to estimate selling floor space and turnover. From detailed analysis of individual occupier's accounts, FSP project typical rent to sales ratios and these are used to estimate the sustainable rent for each unit in the asset. When compared with passing rents, the degree of variation in the sustainable rent indicates whether a retailer is 'vulnerable', 'viable' or 'thriving' in terms of Trading Risk. Results are then plotted on a scheme plan to visually indicate the location of specific units and potential problem malls.

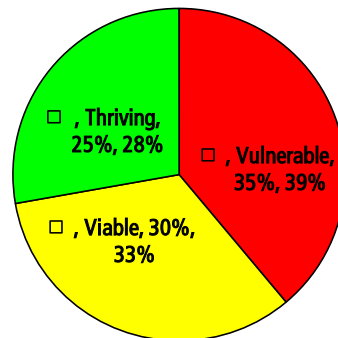


The diagram below from a project in the Republic of Ireland illustrates how assessments of each individual unit in a tenancy schedule can be aggregated to indicate the proportion of total scheme rental income subject to Trading Risk. In FSP's experience, typically about one third of shopping centre rental income is currently Vulnerable (i.e. sustainable rents are 25% below passing rents) suggesting that the particular scheme might expect increasing vacancy difficulties in the near future. However, the analysis also shows that a 12% increase in turnover would be sufficient to return the scheme to a more 'average' level of risk.

Estimated Current Turnover



12% Uplift in Turnover



There have been many occasions where strong performing stores have been closed as a result of failures elsewhere in a chain and it is therefore important that assets are considered in terms of both Trading Risk and Corporate Risk. FSP uses a Viability Matrix to show the combined impact of Corporate and Trading Risk on scheme rental income. On the Viability Matrix below, Corporate Risk is shown along the vertical axis and Trading (or Unit) Risk is shown along the horizontal axis, with the ideal balance of rental income (indicated by the Percentage figures) being located in the bottom right hand corner of the matrix. Asset Management activity can then be focused upon those occupiers who account for the 23% of rental income who fall within the Head above Water & Vulnerable, Healthy & Vulnerable and Very Worrying & Viable cells.

| | | Unit Risk | | | | | |
|----------------|------------------|---|---|---|--------------------------------------|---|---------------------------------------|
| | | Vulnerable | Viabile | Thriving | | | |
| Corporate Risk | Very Worrying | | Superdrug Julian Graves Fineweave Carpets Starbucks | 0% 10% 0% | | | |
| | Head Above Water | Stead & Simpson Sony Centre Robert Dyas | Bon Marche Shoe Zone Diamonds and Pearls Sweatshop | D&A Vision Express Currys digital Greggs | Poundland Waterstone's Millets | F Hinds | 9% 21% 1% |
| | Healthy | Card Factory Holland & Barrett | Specsavers Clinton Cards Early Learning Centre Subway | WH Smith Clarks Ernest Jones Gamestation | Sports World Evans Burton | The Body Shop Boots the Chemist Dorothy Perkins | Sainsbury's Central Topshop/Topman |

The combined assessment of Trading and Corporate Risk is a tested and successful approach which locates retail risk within assets and establishes the scale of improvements required to successfully ameliorate unsustainable occupiers. Deployment of the methodology has achieved notable success including the reduction of rental risk from 43% to 7% at one prime asset, the migration of sustainable rents from 20% below passing rents to 10% above and a 76% growth in rental income over 4 years.

The final Product Focus in this series will discuss the main techniques used to identify opportunities and achieve this Income Growth. More information can be provided through FSP's consultants.



**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