IMAGE: ECE

KEY PERFORMANCE INDICATORS III – LET'S TALK ABOUT LEASE LENGTH!

An important metric used by real estate investors to measure the overall tenancy risks of multi-tenant properties like shopping centers is the Weighted Averaged Unexpired Lease Term.

BY STEFFEN HOFMANN

In view of a quasi-zero-interest rate environment in most industrialized nations today, institutional investors are shifting a more substantial share of their global asset allocations towards real estate as an asset class. Traditional fixed-income investments simply do not provide investors with the desired yield levels that they did previously. Even though transaction yields in some European markets are hitting historic lows, on a relative basis, real estate allows for more attractive income yields than the wide range of fixed income products and other benchmarks. As long as investors acquire the right underlying real estate asset, capital growth can be driven through active asset management.

In this setting, income-producing shopping centers, with their diversified income stream generated through a multitude of retailers, are a sought-after real estate segment. Due to a notorious scarcity of suitable investment stock, contributors of capital had to move somewhat higher up the risk-curve during the previous investment year 2015. Nevertheless, the majority of institutional investors keep looking for core/core plus allocations with premium prices being paid for fully let retail properties with grade A tenants on long leases. When it comes to lease length, many conservative investors are evidently of the opinion that the longer the lease duration at acquisition date, the better. The rationale behind this is simple: index-based long leases are perceived to deliver predictable investment returns and provide their investors with secured, long-term, inflation-proof rental income, while retaining long-term capital growth potential for the distant future. All right!

THE LONGER THE WAULT, THE BETTER THE INVESTMENT?

An important metric used by real estate investors to measure the overall tenancy risks of a multi-tenant property such as shopping centers is the so called **WAULT.** WAULTs will be accounted for and highlighted on every key figure page of the transaction documentation. They assess the likelihood of a property going vacant. The abbreviation WAULT stands for the **W**eighted **A**veraged **U**nexpired **L**ease **T**erm. WAULTs are measured in years. This widespread KPI is mathematically calculated across all tenants as the sum of the remaining contractual fixed rent of an asset divided by the contractual annual rental income of this asset at a specific point in time. In this context, it is worth noting that potential lease renewal options could theoretically extend the term of a lease agreement beyond the first expiry date, however such renewal options are not considered when calculating WAULTs as their exertion is uncertain and uncertainty, after all, is what investors aim to minimize when calculating risks.

Unsurprisingly, investment properties with long WAULTs not only attract large institutional players like pension funds and insurance companies, they also achieve stunning debt-finance-rates as commercial real estate lenders are even more rigorous risk-minimizers and seek certainty in cash flows in order for their loans to be repaid. Risk managers for both, investors and banks, obviously assume that properties with long leases face the least risk of income loss and value decline.

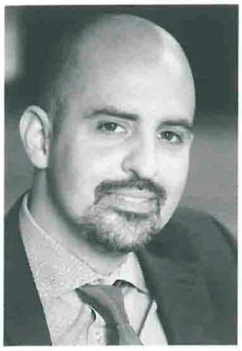

IMAGE: IMALLINVEST

ABOUT THE AUTHOR

Steffen Hofman is Founder and Chief Executive Officer (CEO) of iMallinvest Europe GmbH. He is a genuine European Retail Asset Management specialist with more than 15 years of shopping center industry experience. Having operated in six international markets (Germany, Austria, United Kingdom, Spain, Portugal and Italy) he displays a sophisticated understanding of shopping center mechanics and has successfully built up a valuable relationship network with renowned sector specialists.

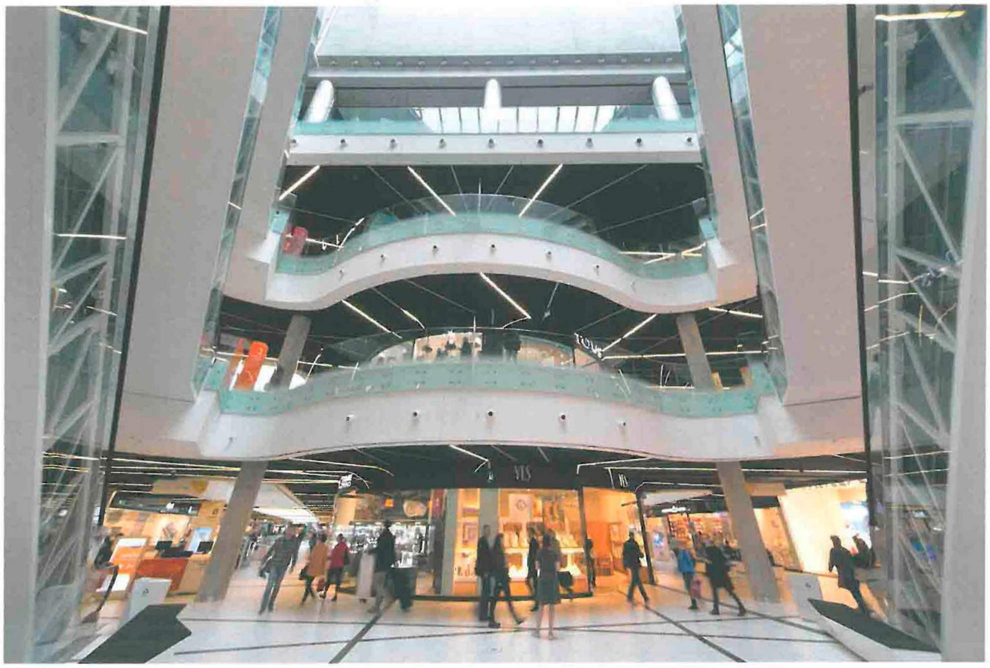

IMAGE: APSYS

WHAT'S THE OPTIMAL LEASE LENGTH?

Let's face it: Right from the outset, an optimal lease length does not exist! As a matter of fact, some regional markets in Europe are used to quite different standards in terms of the ordinary length of a lease. In the UK and Germany, for example, retail players are familiar with 10-year standard leases. Department stores anchoring shopping malls in the UK often even sign up for 15 to 25 years. The previous lease regime in France led to nine-year leases (with theoretical tenant rights to vacate the premises every three years), the new regulation encourages 10-12 year leases. In the Italian market, five- to seven-year leases are the prevailing standard, whereas we often find six-year leases in the Portuguese shopping center market and five-year leases dominating Spain. And guess what? We find good and bad shopping center investments in each of these markets! This means WAULTs must not be the most important determinants when it comes to retail investment success!

Everybody will agree that investors always need to accept some level of risk in their acquisitions—otherwise risk premiums can't be earned as compensation for tolerating that extra risk. So why not go for shorter leases? Well, that's exactly what sector specialists are currently doing. Unlike uneducated investors or sector novices, sophisticated retail investors do indeed give less importance to WAULTs. They have learned that long leases are not necessarily the best leases—and definitely not across the entirety of tenants in the wide mix of a shopping center. Clearly, particularly in the early phase of a development project, both, investors and their debt financing partners, want to see anchor tenants signing up for a 10- or even 15-year long-term commitment to a new store location. Otherwise, the project simply won't fly. Securing anchor tenants long-term is crucial when commercializing the remaining retail space to further retailers. Experienced investors, however, should not be afraid to accept a range of shorter leases for small units (SUs = shops <500 sq m) and, in exceptional cases, also for mid-sized units (MSUs range from 500 sq m to 2,500 sq m) in a shopping mall – in particular if they see themselves as active asset managers.

As long as central KPIs (e.g. footfall, sales, space productivity, and occupational cost ratios) display a healthy picture of the investment property, shorter WAULTs of 3.0 to 4.5 years should not be a threat to investors in our opinion as, with sufficient preparation time, perceived income risks can be competently mitigated through active asset management. That's the beauty of retail asset management! Lending partners, which are usually less

IMAGE: CITYCON

close to the properties than asset managers, can be taken on board by way of providing performance data and explaining the asset management business plan to their risk managers. Furthermore, even if banks apply an additional risk margin over standing asset loans with shorter leases (e.g. due to German Pfandbrief regulations), in the current environment, the attainable debt-finance terms will still promote investment returns. Let's remind ourselves that the European central bank's interest rate is still as low as it can get and we are currently observing a negative Euribor in the European money market!

FOUR IMPORTANT REASONS WHY SHORTER LEASES CAN EVEN BE BETTER LEASES

1. Our experience shows that retail investors should always aim for a good level of tenant rotation during the hold-period of an asset just to keep the tenant-mix fresh. Proactively seeking to rotate 5-10% of the Gross Lettable Area in a shopping mall every year will pay off in the long-term. In this way, landlords keep providing their local customers with an attractive retail offer and are able to defend market share in a competitive environment against new market entrants. When it comes to tenant selection, shorter term leases simply give more flexibility and landlords stay in control of their premises.

2. If the strategy of the investor is to acquire and reposition an established shopping mall to unlock anticipated ERV potential, occupiers with long leases might easily block important access to strategic shop units. Securing vacant possession of all required units to implement strategic business plan milestones can be a costly exercise whenever landlords find themselves forced to buy out their own tenants from existing leases. In such cases, single-sided lease renewal options for retailers can hammer investment returns. A best-endeavor clause, whereby tenants can be offered an alternative space of similar quality somewhere else in the mall whenever the owner wants to refurbish the property is, from a legal point of view, nothing but an empty phrase.

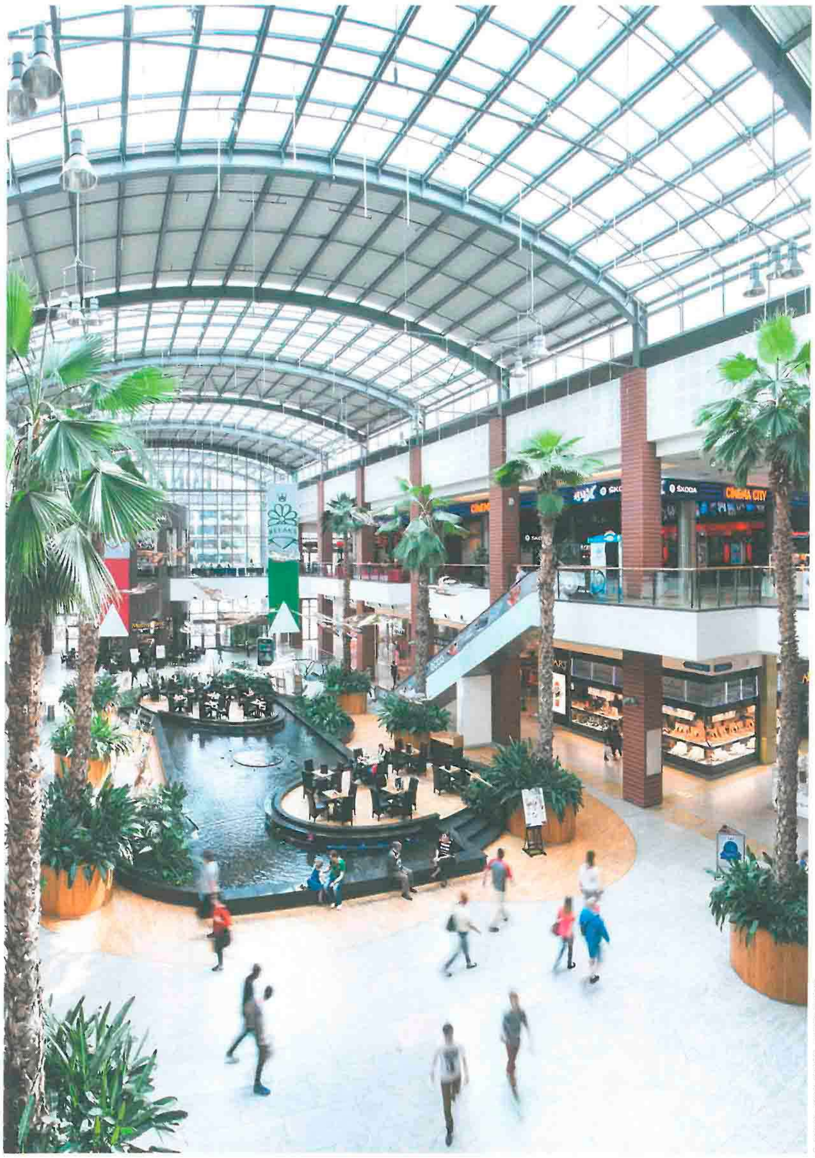

IMAGE: BONARKA CITY CENTE

3. If the investment is made at an early point in the market cycle, at which rising rents are expected to come through, investors are well advised to keep some leases shorter and gradually access rental growth by way of repeated lease renewals, carrying out more frequent re-leasing activities–even if they face additional costs in terms of leasing agent and legal fees. Investors who understand their property performance data will be able to gain the security of continuous occupation, along with the opportunity to increase their rental income and alter lease terms and conditions with subsequent leases in line with evolving market requirements.

4. Landlords will miss out on attracting new market entrants if they are not willing to accept shorter leases here and there. While the cost of fitting out a store and filling it with inventory is substantial and thus not easily amortized over a lease term that is too short, signing leases of between five and seven years can actually make economic sense for retailers to test out a new market or shop format. Bearing in mind that, in Southern European legislations in particular, shorter lease durations prevail, landlords of Northern European retail assets likely need to compromise on lease length if they wish to integrate trendy fashion brands coming from these regions into their international brand-mixes.

GETTING THE MIX RIGHT MEANS ACCEPTING SHORTER WAULTS FOR SMALLER UNITS!

As outlined above, long-term leases offer stability of income and guaranteed tenancy–at least on paper. The obvious disadvantage with that pictured long-term income stability is that retail is a quite dynamic industry that undergoes severe changes. Just about nine years ago, for example, none of us had an iPhone, because smartphones simply did not exist. Investors who bought a brand new shopping center with a WAULT of 10.0 in 2006 will desperately yearn to get some long-occupied rental space back in the course of this year in order to optimize an outdated tenant-mix. Thanks to rapid technological progress, the retail landscape has changed and the business of retailing will keep changing. From an asset management perspective, there is nothing wrong with change, as long as we can develop the shopping center positioning in the right direction. When it comes to retail asset management, income stability, on the face of it expressed and measured in long WAULTs, is perhaps not exactly the ideal solution. That's why we encourage investors to accept shorter leases for small units–which usually by far outnumber the sum of large units and mid-sized units in a shopping center.