moorfields Corporate Recovery

UK Shopping Centres & Retail

October 2013

Recent headlines heralding the beginnings of a recovery in the retail sector may do little to settle the nerves of investors in sub-prime secondary and tertiary retail space. They have suffered most from a sustained period of wider economic austerity but also from fundamental structural changes to the retail landscape in response to increasingly sophisticated, multi-layered information and technological advances.

Evidence of continuing challenges in the sector is highlighted by the most recent official insolvency statistic, suggesting an ongoing role for the retail restructuring specialists. We explore some of the issues inside this bulletin.

The apparent failure of the government to implement a coherent set of plans following recommendations from Mary Portas – the retail "czar" appointed by ministers in 2011 - and unhelpful developments such as the postponement of the business rates review until 2017, have done little to help the high street. As chain retailers evaluate plans for their estates and move away from underperforming sites, traditional high streets in some areas seem to have been taken over by estate agents, pound shops and charity shops. In the meantime, prime shopping destinations, especially those situated in the South East, are beginning to thrive.

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Restructuring Retail

Looking to the future and lessons from history

As the wider economy continues on the road to recovery one might legitimately conclude that the retail sector now appears to be in increasingly good health. Like for like sales in July 2013 reflected significant growth fuelled by a period of good summer weather, an increase in tourist numbers following last year's festivities and a general uptick in the economy. However, August showed a reversal on July's figures as retail volumes dropped unexpectedly, highlighting ongoing volatility for a sector undergoing significant structural change. Online retail continues to grow and over the course of the last five years has undoubtedly become an intrinsic part of our mainstream shopping habits. At the same time, traditional shops in primary purpose built destinations such as London's Westfield Centres reflect huge demand for smart, multi-functional retail destinations. However, the high street and tertiary retail destination continue to struggle due to lack of demand and excessive property costs.

Alongside the volatile macro-economic forces that have shaped our economy over the past five years, the relentless evolution of computer and information technology continues to drive a fundamental shift in the UK's retail landscape. It is telling that online sales growth continues to outstrip high street sales growth by a significant margin.

Evidence of this is perhaps most visible in high streets and shopping centres that are being forced to adapt to structural changes in the sector and, in some instances, to the insolvency of anchor tenants who have fallen victim to recent declines in disposable income and the inexorable growth of online retail.

Secondary and tertiary investments are most affected, particularly out of town shopping centres struggling to retain a desirable mix of tenants offering a strong covenant and a viable proposition. There is also a marked regional variation, and where demand does exist for secondary investments, the bias is toward London and the South East.

Changes to the retail landscape as a consequence of shifts in consumer behaviour are nothing new. Less than twenty years after the end of the second world war the country's first major suburban superstore opened in West Bridgford, Nottinghamshire, offering the car owning public an opportunity to enjoy a completely new retail experience, imported, of course, from that temple of consumerism - the United States.

The post war era cemented a slow creep away from more genteel and traditional shopping habits, where basic needs were satisfied by visiting the butcher, the baker, the green grocer, the fishmonger and the general store. By the 1950's the concept of the "self selection" supermarket emerged where everything was available under one roof: revolutionary stuff reflecting a desire for ease, convenience and lower prices. This was the foundation upon which retail behemoths such as Tesco were built.

At the same time levels of prosperity were increasing across class boundaries, creating new groups of mass consumers who helped drive a rapid expansion of the retail divisions of companies such as HMV and Dixons. This, in turn, increased demand for high street retail space and was followed by the construction of pioneering purpose built shopping centres such as Birmingham's Bull Ring and north London's Brent Cross.

Once again the retail world is on the march and the changes are not simply a reflection of levels of disposable income. Instead it is that same desire for ease, convenience and lower prices that has been the driving force.

The widespread availability of high capacity internet connections now means that almost anything can be bought at any time from the comfort of an armchair . For many people there is simply less of a need to frequent their local shops. Equally, whilst the internet has played a very significant part in the decline of secondary and tertiary retail space, competition from primary retail destinations has also had a dramatic effect. The range of consumers – a term describing the average journey length consumers will undertake to reach a retail destination – has increased for prime retail space offering shopping, entertainment and dining under a weather proof roof. People now shop in a less perfunctory manner and look to combine shopping with entertainment. As a consequence, there is less demand for local secondary and tertiary space.

The effect of economic and structural change in the retail sector has undoubtedly been reflected in a number of high profile retail casualties. In January 2009 Woolworths – a household name that had graced the high street for one hundred years – went into administration leading to the closure of all 807 stores. Ironically the brand "Woolworths" survives as an online retail destination.

The list goes on: Focus DIY, HMV, Habitat, Game, Republic, Aquascutum, Nicole Fahri, Clinton Cards and Comet, to name but a few. Sobering reading for any landlord.

With this in mind, we turn to the role of our property restructuring professionals in successfully navigating the inherent risks and potential pitfalls of managing, enhancing and disposing of shopping centre and retail assets in a challenging market. We also turn our thoughts briefly to the retailers themselves – tenants of the retail property investors - and how we are able to use our experience as insolvency practitioners, as well as our knowledge of the landlord side of the deal equation, to develop optimal work out and recovery strategies. Finally, with research conducted in 2009 by the trade body R3 indicating that 25% of corporate failures were caused in some capacity by the failure of another business, it is worth considering the degree to which distress up and down the supply chain can impact retailers from both an operational and financial perspective.

Distressed retail property investments

Given the gap that remains between the price expectations of buyers and sellers, innovative thinking is key to devising the most appropriate workout strategy and our dedicated team should be the first point of contact for a lender faced with distressed retail asset.

Our initial Options Analysis will focus on a number of key considerations, including:

- the physical quality of the assets and the requirement for CAPEX;
- location and market trends for similar assets in a similar location;
- the local and national planning policy framework;
- the planning history of the investment and compliance breaches;
- tenant profile and covenant ;
- passing rents relative to the market;
- the WAULT (weighted average unexpired lease term);
- the existence of rent deposit deeds and, critically, the deposit themselves (all too often, these have "disappeared" into an overdrawn trading account);
- expected yields and market trends;
- restrictions on title and registered security;
- creditor pressure;
- expectations of management company cooperation;
- the nature of the lender's security and its ability to capture rent under a fixed charge;
- the ability to recover VAT;
- revenue and capital taxation.

Ultimately a lender may seek to take some enforcement action allowing them to recover their loans, costs and accrued interest whilst minimising adverse publicity, and we will devise the most appropriate plan having first agreed the commercial drivers and overall objectives.

Once an enforcement strategy has been agreed and we are appointed as either Fixed Charge Receiver, Administrator or Light Touch Administrator, we will discharge our statutory duties and adopt a role as project manager, overseeing the development, agreement and implementation of strategy alongside carefully chosen property advisors and legal professionals. Our role as "ring master" delivers a number of benefits to lenders:

- the ability to run a "beauty parade" selecting and appointing a team of diverse professionals driven to deliver the best outcome at least cost;
- the capacity to negotiate hard on fees;
- the ability to change agents should they not be delivering the required outcome;
- the ability to act as a central resource driving activity and ensuring common objectives are met.

At Moorfields, our dedicated property team has a wealth of experience advising property lenders to the retail sector. We focus at all times on delivering the best outcome at least cost and are here to help. We also work alongside a number of trusted property specialist.

Retail distress

We have already highlighted how a fundamental shift in consumer behaviour arising as a consequence of social and technological changes has been driving a revolution in shopping habits. This, in turn, has given rise to a massive acceleration of online retail and in the fortunes of innovative high street retailers who are able to move with the times. However, for those who cannot, it has given rise to a wave of retail insolvencies.

Jessops, the photographic equipment retailer, is a great example of a business which failed to adapt, becoming little more than a show room where consumers would source and physically inspect a product before buying it online for less.

However, all is not necessarily lost. Such business tend to have large leasehold estates in the high street so their leverage with landlords can be significant. There has been an increase in the number of Company Voluntary Arrangement proposals seeking to compromise lease terms to help secure the longer term viability of the business model. It is here that our experience on both the landlord and tenant side proves useful and we continue to advise a number of distressed retailers on how to restructure. Indeed, we have a significant expertise in advising retailers outside of and in an Insolvency process.

Equally, we have been speaking to some large national retailers about the inherent risk of supplier failure and how this could give rise to operational disruption to their business. It is surprising how few have considered these significant risks in a meaningful way.

The overview set out above hopefully brings to life how the world of retail is changing and how the consequences across the piste, from the property investors in retail assets to the retailers themselves and beyond to their suppliers. Over the following pages we focus in a little more depth on the property side.

Joshua Vernon of Jones Lang LaSalle provides a summary of activity in the investor market and sets out some useful statistics on pricing across the sub-sectors. Sam Pilgrim of Savills plc talks us through the pitfall of property management in a retail asset enforcement scenario. Finally, Simon Wantman of LAMS, a division of London & Associated Property plc, sets out some of the key issues when undertaking a retail asset management project

We hope you find these insights useful and would welcome the opportunity to discuss them with you.

Paul Zalkin
Head of Property Solutions
Moorfields Corporate Recovery

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Quarter 2 Summary

During 2013, the shopping centre investment market has seen a large number of transactions completed. To date the market has witnessed 39 transactions with a total volume of £2.215 billion which is approximately 75% of the entire volume transacted in 2012 and 54% higher than the volume transacted to the same point last year. There is strong demand for prime, regionally dominant centres, with a number of REIT's International Funds and Sovereign wealth funds seeking to purchase dominant shopping centres.

2013 also saw an increase in the amount of capital targeting secondary shopping centre assets, and as a result there has been a hardening of yields in this market. The improvement in pricing for secondary centres has predominantly been driven by increased competition among investors as opposed to an improvement of the occupational market.

Prior to 2013 the secondary market was dominated by opportunity funds however recent activity has seen a return of institutions into the sector. Within the secondary market, there remains a preference for resilient schemes with a bias towards London and the South East.

Legal & General's acquisition of The Dolphin Centre Poole for £57.7m reflecting an initial yield of 7.81%, and M&G Real Estate £88m acquisition of the Gracechurch Centre Sutton Coldfield for 7.75%, are both examples of institutions moving up the risk curve back into the good secondary market.

The Mall in Uxbridge was purchased for £64.5 million reflecting 7.8% net initial yield by LaSalle Investment Management on behalf of the Mars Pension Fund. Despite being the second scheme in Uxbridge, and a number of tenants not be recognised covenants, it highlights investors preference for London based schemes.

The Bouverie Place shopping centre in Folkestone was purchased by Tristan Capital Partners and Ellandi for £21 million reflecting a net initial yield 9.25%. It was put up for sale by joint receivers of Warner Estate Development (Folkestone) and Warner I. The centre was developed in 2007 and as a result was significantly over rented. The scheme did, however, benefit from a weighted unexpired term of close to 10 years. The achieved pricing reflects the over rented nature of the property as well as the relatively weak demographic. More challenged assets such as the Ankerside centre in Tamworth appeal to a smaller pool of investors due to intensive asset management required and the short term lease profile. The asset was purchased by LaSalle Investment Management achieved a price of £15m reflecting an initial yield of 10.75%.

While institutional demand has returned for good secondary, the pool of investors for poor secondary and tertiary schemes still remains relatively thin which is reflected in the pricing of the assets. Investors operating in the poor secondary and tertiary markets are aware of the risks associated with the future performance of these assets. Retailers continue to streamline their portfolios and are vacating stores not making a valid contribution and of course poor secondary and tertiary schemes are most at risk to this. As a result, this sector of the market suffers from an oversupply of retail space and a lack of demand which continues to put downward pressure on rents. The pricing of these assets often 9-10%+ reflects the risks associated with these types of assets.

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Jones Lang LaSalle®

Managing a retail property through insolvency

During the prolonged economic downturn, retail insolvency has come to the fore as retailers have been squeezed by both suppliers (especially landlords insisting on rent being paid quarterly in advance) and changing consumer habits. This has culminated in an increase in the number of retail insolvencies and some well publicised high profile casualties which, in turn, has placed pressure on retail landlords.

As a consequence there has been a notable increase in financially distressed high street and shopping centre investments – particularly secondary and tertiary assets in blighted areas – and an increase in the number of shopping centre administrations and fixed charge receiverships.

Key to successfully managing a retail property investment through an insolvency process is preparing the asset so it is ready for sale, by balancing the requirements of the lender, the landlord, tenants and the consumers who use the space. This involves cost mitigation, reviewing added value opportunities and maintaining the income stream.

The property management process for distressed retail investments can be broken down into 3 distinct phases:

Front End (i.e. on handover/instruction):

Set Up – Ordinarily a handover is arranged to solicit as much information as possible in terms of property documentation and financials. However, given the distressed nature of the assets it is not uncommon to receive very little cooperation and information from the incumbent property manager, especially when the defaulting borrower has previously fulfilled this role. Reliance may have to be placed upon existing tenancy schedules in the interim whilst lease documentation is identified.

The initial focus is to set up the tenant properties in order to demand rents/service charges and to ensure rents are collected in a timely fashion so cash flows can be preserved. This is critical as costs will need to be met from the rents collected. Every effort should therefore be made to ensure that the previous manager cooperates with the handover process. This requires careful management to ensure as much information/documentation is passed across.

Information Management – once Set Up has been completed the information on the properties has to be reviewed to ensure that any documentation is accurate and current. This forms part of the process of ensuring the assets are compliant from a statutory, health and safety perspective. The aim is to create and organise a database as early as possible to ensure the assets can be managed smoothly and prepared for sale. It is also imperative that the lending bank, the Receiver or Administrator have access to this information so informed decisions can be made.

Tenant Engagement – An important factor from the outset is to understand the tenants' businesses and communication with tenants is key, for instance to ensure they pay their rents to the correct entity and so an understanding of they how they trade can be developed. This may highlight opportunities to enhance the assets by way of re-gears, rent reviews or the removal of break options. Effective communication helps ensure a successfully performing asset.

Mid End (following initial Set Up):

Property Review – Once the front end issues have been dealt with, a more detailed asset review should be undertaken and a property management strategy formulated. This will involve reviewing the supplier base and ratings liabilities in order to identify opportunities for cost mitigation (such as void liabilities), as well as seeking opportunities to add value in order to improve the overall net operating income. This should make the asset more attractive to a potential purchaser.

The review would also include looking at installing temporary or permanent lettings and reviewing the service charge budget and contracts to understand where any "fat" may be trimmed to decrease the liabilities and reduce overall occupational costs.

Adding value can take the form of any initiative that enhances the net operating income of the asset, including reviewing commercialisation opportunities in any communal areas or mall space or lease re-gear opportunities. In addition, and where they exist, income generating car parks may be reviewed in terms of tariffs and banding to ascertain whether there are any opportunities for uplifts.

Back End (readiness for sale) :

As part of any distressed property instruction the asset must be readied for sale.

The property manager plays an important role ensuring information is collated and made available as part of the sale and due diligence process, and in preparation for a smooth onward transition to a purchaser following completion. It is then over to the sales agents to identify a purchaser and complete a sale.

Conclusion

Such is the scale of the structural changes to the retail landscape that in 2011 ministers appointed Mary Portas as "retail czar", tasked with carrying out a review to suggest how our high streets and retail spaces could be regenerated. More recently, Bill Grimsey (formerly of DIY chain Wickes and food retailer Iceland) has produced an alternative view speculating that up to 20,000 independent shops could disappear.

Portas and Grimsey have a very different views of how the issue should be tackled. However, ignoring which of them is correct, the implications for investors in retail assets cannot be ignored.

When confronted with a shopping centre that is subject to an insolvency process, the property manager's role is to take control and to balance the requirements of the lender, the landlord, tenants and the consumers who use the space.

Understanding the assets from a financial and operational perspective is key, as is regular communication with tenants to ensure their needs are being addressed.

Ultimately, a coordinated strategy and team work between the administrator or receiver, the asset manager, the property manager and the sales agent is the means by which a successful outcome will be achieved.

Author:
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Savills

savills

“Straight-forward solutions are the prime focus for Moorfields Property Solutions team.”

Multi Centre & Retail Management

As has been widely reported, shopping centres and traditional High Street shops have suffered considerably as a result of both the recession and the structural shift in shoppers' habits as they move to the online retail world. In towns around the UK where there has been significant development of new shops in recent years, this has led to a serious over-supply of retail space competing for an ever-diminishing number of occupiers.

Understanding any shopping centre asset prior to embarking on a turnaround exercise is essential, and as such, carrying out a full strategic review is probably the only place to start. This review is based on a full tenant audit, during which the key objective is to establish how a tenant is trading, whether there are opportunities for relocation or reconfiguration and whether there is any scope to improve cash flows and capital values via the negotiation of re-gears, removal of break clauses etc. It is also important to carry out a full gap analysis to see which tenants are not in the town, and ask them why.

Additionally, it is important to generate on day one a detailed knowledge of ongoing tenant matters including debtors and payment plans, service charge and building issues, although this can be a minefield where over-optimistic budgets and management reporting have been used by borrowers to paint an unrealistically positive picture in order to keep their lenders off their backs.

In certain situations it is not uncommon to experience a lack of management cooperation once a borrower accepts the inevitable and realises they are going to lose control of the asset. However, lenders can mitigate this risk and prepare the way - particularly once a decision to enforce is taken - by requesting regular management information from the borrower, including debtor and service charge expenditure reports.

Failure to secure current information means embarking on a forensic exercise in order to re-build a full record of management information. This can be time consuming, expensive and ultimately will impact on value at the time of disposal if the records are incomplete.

At the same time, a change of management often brings positive benefits. For example, a new manager can re-engage with a Local Authority who may have become frustrated at the likely lack of investment in an asset.

The support of the Local Authority can be essential in ensuring that any projects that will involve planners, highway engineers or other Council departments progresses as smoothly as possible. Councils play an enormous role in any turnaround of town centre retail and having a manager with a successful track record is key.

Equally, potential tenants are wary of spending time and money considering proposals for a new unit if an asset manager is associated with a borrower who is cash starved. New lettings, particularly as part of a turnaround, are frequently financially painful for a landlord, and a tenant is unlikely to pursue opportunities, no matter how generous the terms on offer, if they have no confidence in the deliverability of the project. A new asset manager, with a proven track record of delivering complex deals, can make the difference between agreeing the transaction and not.

Moving away from development capital expenditure, we have often experienced serious under-investment in the building fabric of Shopping Centres. This is particularly prevalent in Centres with a number of vacant units, as the landlord has not been willing or able to invest in the Centre. This lack of investment can be a ticking time-bomb if not dealt with early on.

Turnarounds need not always be cash intensive. Success can be achieved by lining up unit amalgamations or sub-divisions with pre-lets and planning consents in place - a relatively good value albeit complicated and tricky exercise - and selling the asset to a new owner with the benefit of the uncompleted contracts.

“........ this can be a minefield where over-optimistic budgets and management reporting have been used by borrowers to paint an unrealistically positive picture in order to keep their lenders off their backs.”

Multi-let retail assets are, by their nature dynamic, and constantly requiring management. It is therefore essential to bring in appropriate experienced management at an early stage to ensure that taking control of the asset is done with the minimum of disturbance. A new manager, with a good reputation and strong track record is an essential first step towards the repair of fractured relationships with tenants and Councils alike.

Since strategic reviews can take several months, engaging such a manager at the first sign of potential enforcement is, in our opinion, essential.

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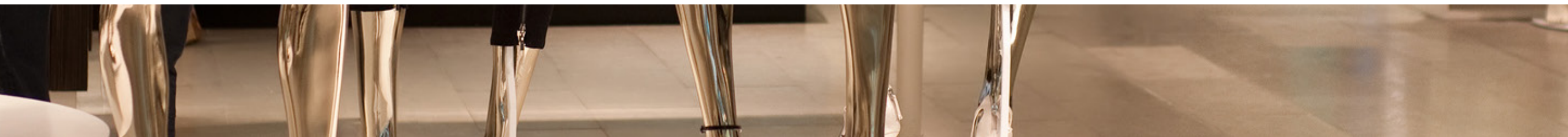

Moorfields Portfolio Sale

The Espedair Portfolio

Scotland
£8.75m

An exciting 25 property portfolio in Scotland incorporating retail, office, industrial and leisure investments, including a multi let office in Glasgow city centre, 10 Martin McColl shops, a bank and residential assets in Aberdeen.

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Savills
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Important information - The portfolio is being marketed for sale by Simon Thomas and Shelley Bullman in their capacity as Joint Administrators ("the Administrators"). The Administrators were appointed on 14 February 2013 and now manage the affairs, business and property of the company. The Administrators act as agents only and without personal liability. Disclaimer – This information is communicated as a general guided only. Interested parties should ensure they carry out their own investigations and obtain independent professional advice. The information provided does not constitute as property particulars.

Moorfields Property Solutions

Our specialist property team is dedicated to supporting secured lenders in handling some of the complex issues arising in property insolvency. Unlike many other firms our property team dedicate 100% of their time to property assignments so are constantly up to date with the latest developments and market related issues.

Our expert knowledge and understanding of different types of property mean we can readily identify the most appropriate strategy.

Our focus is to offer a dedicated service with straight-forward options and realistic solutions to ensure we maximise the financial outcome for our clients and business stakeholders.

Want to find out more?

To find out more about Moorfields' restructuring and insolvency services contact: Simon Thomas on 0207 186 1143.

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