EXPLORING NEW LEASING MODELS IN AN OMNI-CHANNEL WORLD

ICSC

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FOREWORD

It is already clear that all aspects of the shopping centre industry are being transformed by today's rapidly evolving digital era. This study examines in detail how one especially fundamental core function is being affected: leasing.

Shopping centre landlords and tenants are adapting to a 'new consumer' using home computers, tablets, smartphones and in-store kiosks or sales associates to research, experience and decide on a product. That more complex consumer journey is presenting an additional challenge to the owner-tenant relationship, forcing the realisation that the longstanding leasing model, based on metrics involving in-store sales, needs to be reexamined.

The goal of this report is to start a conversation on this subject and raise awareness of the emerging options. At the same time, it affirms not only that the store remains the cornerstone of sales and marketing strategy in the omni-channel environment, but also that the value of a location now encompasses more than simply the sales generated by that physical outlet.

Despite the powerful forces of globalisation, local, regional and national markets retain their individuality, so a 'one-size-fits-all' approach would be inadequate in addressing this multi-faceted situation. For that reason, this study analysed the results of extensive interviews in both the United States and Europe, finding multiple variations in how respondents are anticipating the new state of affairs—and offering signposts for those traveling down this evolving path.

The multiple headwinds affecting the retail real estate industry worldwide in recent years have only reinforced the need for farsighted leadership that continues to advance companies through unfamiliar waters. Part of that leadership requires embracing technology that promises to alter even further relationships between consumers and businesses and between owners and retailers. This report has been written—and is now being offered—in that same confident spirit.

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EXECUTIVE SUMMARY

This research reviews the revolution of omni-channel retail and examines how owner and retailer business models are adapting to the digital era. A revolution in omni-channel retail is altering or will soon alter traditional retail rent/leasing models. In this report, we analyse the impact of this massive transition on optimal retail rent leasing models and examine how both tenants and landlords are adjusting to change. The analysis is based on primary and secondary research, including the findings from approximately 90 interviews with representatives of retailers, shopping centre owners and other industry experts, and from presentations to special interest groups within the ICSC, involving over 200 members across the United States and Europe. Consequently, the project has sought to give a voice to the industry on the future direction of retail leasing and rental metrics. Rather than attempting to prescribe one specific leasing model form or set of forms, this report provides a toolbox that includes a wide spectrum of possible alternatives to aid the industry as it considers and develops future leasing models.

The key findings of the research are:

- **New technology, in tandem with wider structural economic and societal macro trends, has facilitated and accelerated changes to consumer buying behaviour.** The consumer decision-making journey is more complex, involving cross-channel shopping activity—often in real time— pre-, during and post-purchase. The permutations of shopping patterns are manifold, varying not only across consumers, but also with the mode and mood of any one individual. Most retailers and owners are implementing omni-channel business models to harness such change and better meet the expectations of the new consumer.

- **The scale and rapid pace of change requires a major restructuring of retailer business models across multiple dimensions including inventory management, distribution, customer insight, merchandising, marketing and accounting.** Even the most advanced retailers have yet to fully implement their omni-channel strategies.

- **Far from diminishing the role of the physical store, digital retail has expanded it.** Most omni-channel strategies are anchored on store portfolios, with their value extended from being a point of sale (POS) to the backbone of omni-channel sales and marketing strategies. Consumers are engaging with multiple in-store and online touchpoints before transacting. As such, it is the contribution of a store to a sale that matters, not the POS.

- **Equally, many owners have been quick to respond to this digital transformation,** restructuring business and shopping centre strategies to better anticipate and respond to consumer change. Realising that it is no longer sufficient to offer accessible, well-designed centres and good-quality space to retailers, they are focusing on place-making strategies that draw consumers into a central marketplace, thereby helping retailers access customers. This represents a fundamental shift in responsibilities between owners and retailers, as well as a recognition that, to engage and attract consumers, the centre must deliver more than a strong, coherent tenant mix.

- **New technologies are being explored by retailers and owners. As well as engaging with customers and providing them with superior experience and service, this digital infrastructure enables a much deeper understanding of consumer behaviour within the centre and across channels.** These new technologies are still developing and no standard has been established, but most focus on tracking and delivering customer insights. They are increasingly being used as a basis for consumer research and new performance measures and offer the potential for owners to develop new revenue streams.

- **Amid all this digital innovation and change, retail leasing and rental models remain largely unaltered.** Depending upon the current rental framework used by contributors, as well as the function and scale of shopping centres managed, many retailers and owners considered current leasing models to be 'working, but creaking.' As a result, many retail real estate professionals are beginning to reevaluate existing leasing models and rent metrics in the United States and Europe to assess whether traditional approaches remain fit for purpose.

- **Appropriate solutions will vary between different types of centres in terms of scale and function, and between different types of retailers, in terms of sector and brand power. Looking forward, the basis of lease contracts is expected to be derived from one or more of the following three broad frameworks:**

1. **Fixed Rent Models.** These involve a 100% base rent with no additional performance metric, usually subject to either stepped increases over the duration of the lease, or to periodic review, as commonly seen in the U.K. Some retailers and owners familiar with this approach have argued that competitive bidding for a space intrinsically determines the value a store contributes to total sales, including associated online sales. A shortcoming of this relatively simple model is that retailers are not yet able to quantify the value of a store to total sales. Although the rent agreed at the start of a lease might represent a useful proxy, difficulties arise over its applicability over the course of a lease. Given security of tenure, this is complicated for lease renewal in Europe and for periodic rent reviews in the U.K. A further drawback of the approach is the weak alignment of interest between owners and retailers due to the absence of a performance incentive, exacerbated by the greater degree of collaboration between these stakeholders that the shift towards omni-channel strategies implies.

2. **Turnover or Percentage Rent Models.** These types include:

   a. **Conventional turnover rent models**, which include a base, rather like a fixed rent, accounting from 92% to 100% of the estimated rental value. Base rents are accompanied by a performance rent, which are payable as a percentage of store turnover once agreed sales hurdles are achieved. The difficulty with conventional turnover/percentage rate models is that the performance metric is based upon the POS, not the contribution of the store to a sale. As a result, in the U.S., base rents have been drifting upwards, with the percentage rent likely to kick in at a higher level of target sales. Other alternative adjustments offered are to increase the percentage rate applied to sales, but this is only a very approximate measure of the store's contribution to total sales. Some owners are attempting to include click and collect and in-store online sales in the total sales volume, but perhaps at a reduced percentage rate. However, strong omni-channel retailers argue that they are driving footfall and incremental spending to the centre and that attributing the sale to the store ignores their costs of operating the online sales and distribution platform that generated the sale.

   b. **European factory outlet-style leasing models.** Some retailers and owners of more challenged neighbourhood and mid-sized centres suggested, similar to leases implemented in European factory outlet centres, a shift to a lower base rent, lower sales hurdle and higher percentage rate to provide for greater risk sharing, given the greater uncertainty of sales performance in such schemes. An important element of such agreements would be the absence of security of tenure for retailers, with a two-way option to break a lease if pre-agreed sales targets were not met. Again, the contribution of the store to non-store sales is implicit in the base rent.

   c. **Geo-fence turnover models.** Models that include all sales within an agreed geo-coded catchment area have been proposed by a number of owners. Depending on the transaction, a different percentage rate would be applied across different categories of sale, including 'click and collect,' 'kiosk,' and 'halo' in an effort to extrinsically measure the variation in the contribution of the store to different types of sales. However, retailers are generally reluctant to provide turnover data on non-store sales. Moreover, while many retailers are planning to shift towards merging online and store profit centres based upon geo-fencing models anchored on store portfolios, few have implemented this strategy.

3. **Models Using Alternative Performance Metrics.** A number of owners of both destination and neighbourhood centres in the U.S. and Europe suggested that performance metrics should be linked to their operational management expertise, rather than to sales. Many retailers indicated that where owners invest in innovative asset strategies that generate results, they would be willing to accept new performance metrics that take the volume and value of the consumer opportunity into account. A number of retailers explained that finding appropriate metrics to reward owners and managers for delivering a stronger customer opportunity mirrored the difficulty in rewarding sales staff. The more permutations involved in completing a purchase, the harder it is to measure how much good in-store customer service or sales technique contributes to total turnover.

As they determine appropriate and workable rental metrics, retailers and owners will engage in considerable exploration. Many of these experiments relate to existing key indicators already used to develop strategic initiatives and ongoing performance management of the centre and individual occupiers, as well as new metrics to incentivise retail staff more effectively in an omni-channel era. Among the new performance metrics to emerge from the discussions were: net shopping hours; volume of agreed-target customers (not simply footfall); and conversion rates and basket size. Owners advanced in digital strategies stressed the value of the new insights they are able to derive, but acknowledged that as new technologies are still embryonic it is too early to embed them into longer-term lease agreements. However, this area is maturing rapidly and will likely be a source of key performance measures within future rental agreements.

The digital era is creating an unprecedented pace of change as economies and societies embrace innovation. The retail industry is running fast to keep up with rapidly evolving consumer demands and, in doing so, to continue to transform itself to better respond to and anticipate change. In the omni-channel era, leasing models and rent metrics that are based upon POS are losing relevance as a proxy for the contribution of a store to total sales, and new approaches will be required. This research provides a useful framework as the industry considers the way forward. Given that omni-channel retail involves the blurring of two of the most dynamic and innovative industries—retail and technology—it is certain that solutions will emerge.

EXPLORING NEW LEASING MODELS IN AN **OMNI-CHANNEL WORLD**

1.0 INTRODUCTION

New technology, in tandem with wider structural economic and societal macro trends, has facilitated and accelerated changes to consumer buying behaviour. Retailers are responding with a shift toward omni-channel business models. Equally, many owners have been quick to respond to this digital transformation, restructuring business and shopping centre strategies to better anticipate consumer change. As a result, shopping centre professionals are reevaluating existing leasing models and rent metrics in the United States and Europe to assess whether traditional approaches remain fit for purpose. Rather than attempting to prescribe one specific leasing model, this report sets out the full spectrum of possibilities created by these changing conditions, with the aim of providing a useful framework for the industry to consider.

Far from diminishing the role of the physical store, digital retail has only expanded it, from a point of sale (POS) to the backbone of omni-channel sales and marketing strategies.

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Approximately 10% of total retail sales occur online in even the most advanced digital retail markets. It is generally believed that this percentage will increase, as online retail sales gains continue to outpace those of in-store sales. However, focusing on sales allocation is misleading. Viewing POS as a measure of the value of a store masks the complexity of the customer's decision-making journey and the symbiotic relationship across the physical and online sales platforms. Although store turnover as a proxy for store performance has served the industry well in the past, it is becoming less appropriate as a measure of a store's value and contribution to total retail sales.

1 INTRODUCTION

The two major participants in the leasing process have moved in parallel steps to deal with the digital age:

Retailers' business models have evolved from multi-channel operations that managed online and store operations in parallel, into one integrated platform. Most have developed omni-channel strategies with the aim of better responding to their customers' needs and preferences. Though few have established seamless operations,[1] **the physical store remains the cornerstone of retailers' omni-channel strategies**, with a value considerably greater than as a mere POS.

Owners have adapted their own business models. Recognising that they are no longer just offering well-located, good-quality space to retailers, they are focusing on delivering and enhancing a sense of place that drives consumers to a central marketplace, thereby helping retailers access customers. Moreover, in a fundamental shift in the relationship between shopping centre owners and retailers, some landlords are also using new technologies to facilitate the interface between the customer and the store. At the same time, the retailer is relying more heavily on the shopping centre to attract and engage today's demanding consumer.

Amid all this digital innovation and change, retail leasing and rental models remain largely unaltered, with the metrics underlying most rental agreements unchanged.

The aim of this research is to establish how retailers and owners are changing their business models in response to the evolution of omni-channel retail, what their current and anticipated challenges will be, and how these changes are shaping asset strategies, leasing models and in particular, rental metrics.

The findings are based on both primary and secondary research. Approximately 90 interviews were undertaken in Europe and the U.S. with representatives of retailers and shopping centre owners, as well as other industry experts.[2] The contributors are representative of the geographic reach of the study. A series of workshops were undertaken to build upon the preliminary output. Additional input was received during six presentations of preliminary findings to member special interest groups within the ICSC, capturing further feedback from approximately 200 members. As such, the project has sought to give a voice to the industry on the future direction of retail leasing and rental metrics.

2.0 THE EVOLUTION OF OMNI-CHANNEL RETAIL

Bill Gates has suggested that 'we always overestimate the change that will occur in the next two years and underestimate the change that will occur in the next ten'.[3] By 2000, it was already becoming clear that the consumer browsed online and shopped in-store and vice-versa. The biggest impact of the Internet in these early years was the acceleration of competitive pricing, particularly for commodity goods including electronics, books, and music.[4]

Although the digitisation of products themselves was not foreseen as occurred, for example, within publishing, music and gaming, other retailers heeded Gates' warning and developed online channels to help protect and grow market share.[5] Beyond commodity-shaped goods, existing national and international retailers, especially those with an established catalogue channel, had a competitive advantage given their existing brand value strength, customer base, scale and logistics networks. In most markets, the first decade of the 21st Century witnessed a rapid shift from a binary market of pure-play e-tailer vs physical retailer to one dominated by multi-channel retailers and online behemoths. Web-only retailers comprise approximately 30% of total online sales in the U.S., most of which is from one retailer, Amazon. Only some pure-play e-tailers are profitable. As they focus on growth in market share, many of these are establishing some form of physical retail presence.

The emergence and rapid growth of smartphones, tablets and the seemingly exponential rise of the Internet of Things (IoT) since 2010 have further encouraged consumer autonomy. Consumer behaviour is no longer binary; consumers can—and are—shopping simultaneously online and in-store, seeking opinions from personal networks, reading peer reviews, inventory checking and undertaking price comparison in real time. More importantly, consumers have seamlessly integrated technology into their buying behaviour (Figure 1). Such shopping journeys are complex and vary between consumers and across different modes and moods of shopping. Consumers browse inventory, compare and research products online and/or in-store in advance of a purchase. For example, a consumer might research a product online, experience the product in-store, and, after reflection, purchase it online for an in-store pick-up.

POS is one of many steps along this journey and its place is relatively unimportant to the retailer's profitability. Fulfilment of the product is also variable and may be received immediately in-store, collected from store or delivered to home or an alternative address or collection point. The customer journey also extends beyond the purchase decision with the post-purchase experience, which includes reviews and returns, but also presents the opportunity for retailers to make further recommendations and target highly relevant offers to consumers based on their purchase history. This approach requires multi-channel retailers to shift from essentially operating separate retail platforms towards one, integrated platform.

FIGURE 1. Complex Customer Journey

Markets differ in their digital retail maturity in terms of the share of online and mobile shopping penetration. Internet access is a prerequisite to accessing digital shopping. While digital access has fast become regarded as a basic necessity by consumers in many countries, it is not universal (Figure 2).

However, smartphones and other devices offering mobile web access represent an advance towards universal access. They are also a game-changer for consumer buying behaviour.

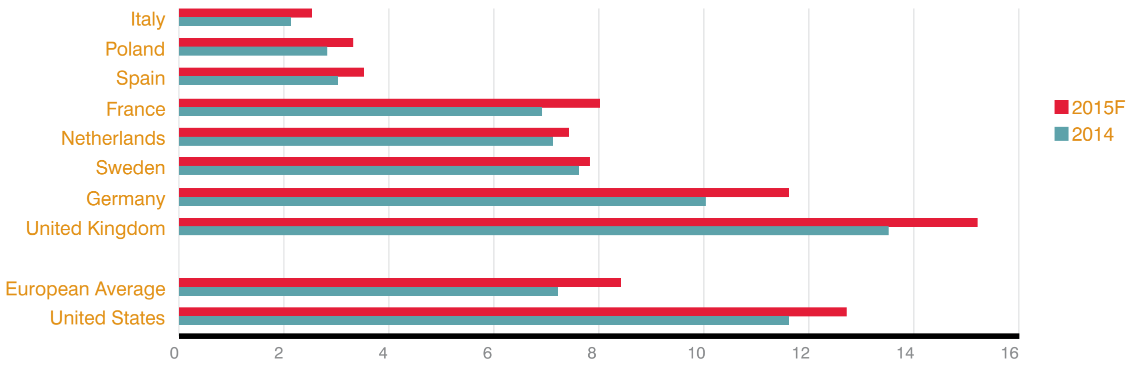
FIGURE 2. Home and Mobile Internet Access, 2014

(Percentage of Individuals)

Sources: M. Meeker, 2015 Internet Trends; Eurostat

Accompanying the evolution of omni-channel retailing is the growth of online sales. To some extent reflecting Internet penetration, online sales growth varies significantly across markets. The U.S., U.K. and Nordic markets have the highest online share of retail sales and also provide the most accurate data. Establishing the rate of growth and scale of Internet sales is difficult as not all markets have reliable data.

FIGURE 3. Online Sales as Percentage of Retail Sales*, 2014 and 2015F



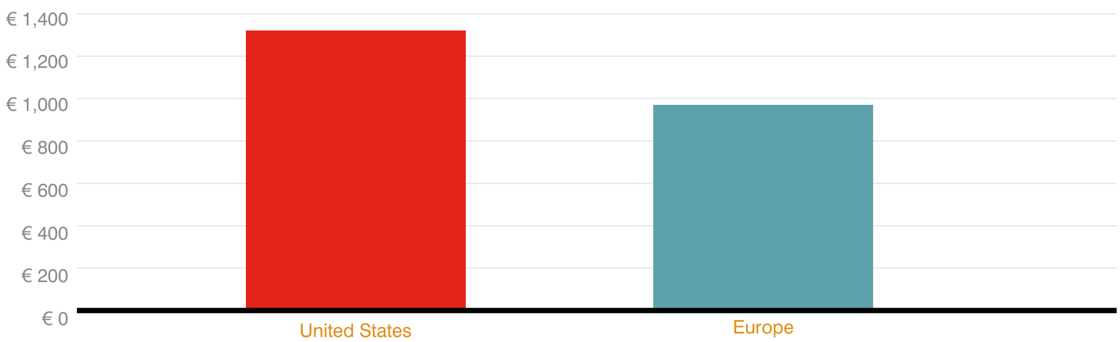
*Retail sales exclude autos, gas, tickets, and sales-weighted transactions.

Source: Centre for Retail Research

In addition, the retail sales category is a broad umbrella and encompasses many sales and services that would not usually be featured in the tenant mix of shopping centres and might be characterised by a high online sales component, for example betting shops, ticketing etc. The Centre for Retail Research has compiled survey-based data that quantify online retail sales including in eight European countries and the U.S., using a narrow definition of retail sales that better reflects retail activities within shopping centres (Figure 3).[6] However, it is worth noting that as the data exclude food and beverage (F&B) services, which cannot be digitised, the online share of total sales may be overstated for total spending across shopping centres.

Using this narrower definition of retail, the U.K. has the highest proportion of online sales at 13.5% in 2014. At less than 3%, Spain, Poland and Italy have the lowest, to some extent reflecting regionalisation in penetration rates and in the quality of telecoms infrastructure beyond major cities. The U.S. achieves a high penetration rate approaching 12%. Looking at spending per capita, U.S. consumers outpace their European counterparts substantially at per capita levels averaging $1,815.52 (€1,325.20/£1,119.79) compared to $1,329.54 (€970.47/£820.05) in Europe (Figure 4).

FIGURE 4. Online Spending Per Capita



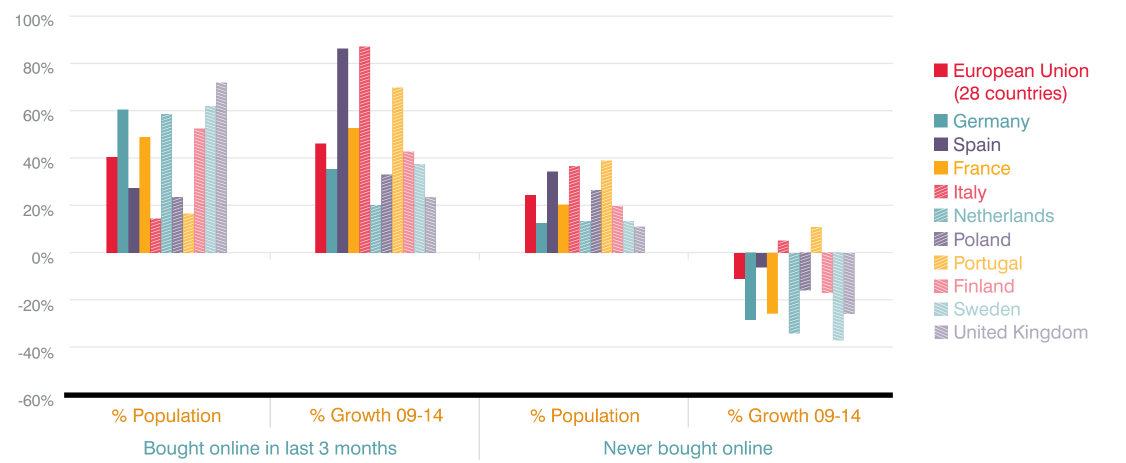
Source: Centre for Retail Research (2015)

In some of the mature online markets, there is some evidence that the rate of growth of these sales is slowing. Individual retailers' performance across channels diverges widely, depending upon their market share, as seen in Figure 5. Those retailers who have established the highest share of online sales relative to total sales have the lowest rates of growth and vice versa, perhaps indicating that online as a proportion of store sales reaches a natural plateau at which growth rates begin to moderate. This trend is also evident in the growth momentum across countries in the number of individuals making a purchase online in the last three months and the decline in the number of individuals who have never made a purchase between 2009 and year-end 2014. (See Figure 6.) Those markets with the lowest penetration rates, like Spain, are characterised by the strongest growth rates, and this holds true across all retail segments where Spain is generally indicative of this trend as well. (See Figure 7.)

FIGURE 5. Online as Percentage of All Sales and Annual Growth

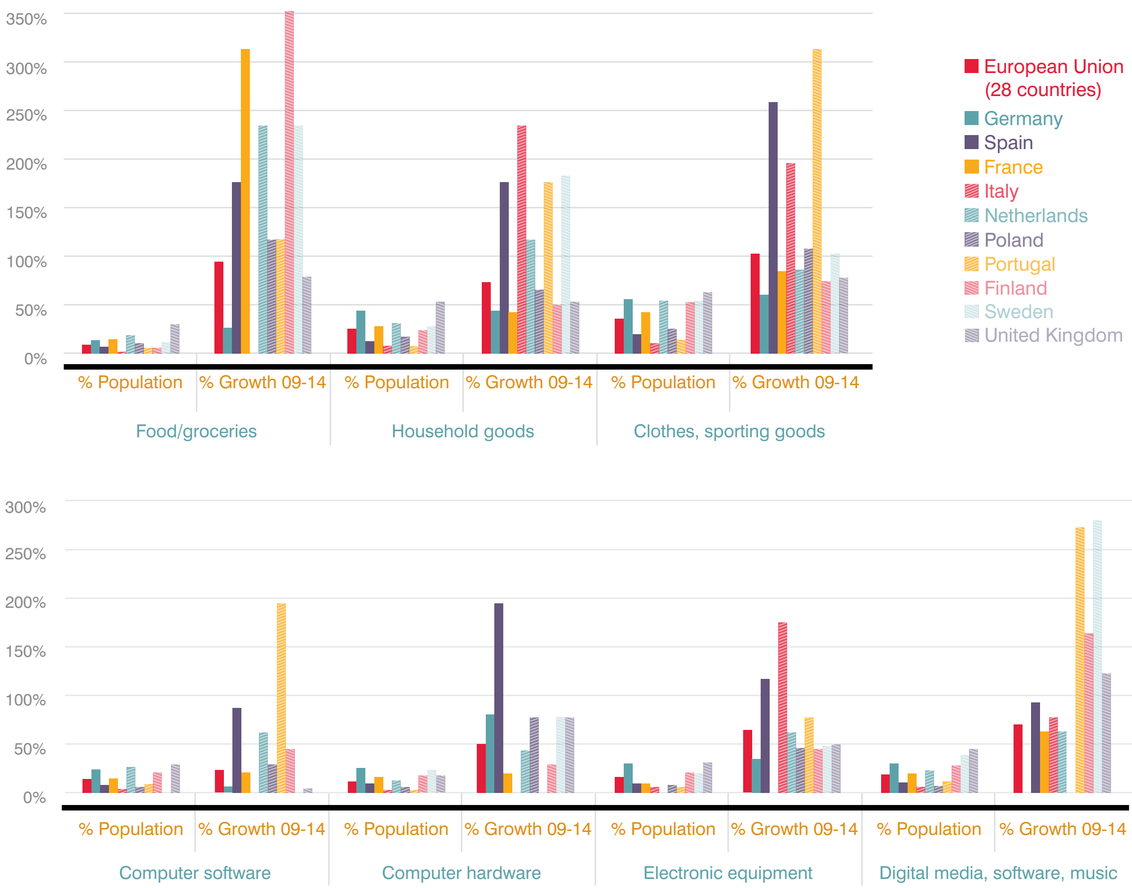
Source: Property Market Analysis (PMA) (2015) based on company reports; Vertical Web Media LLC

FIGURE 6. Online Purchase Activity and Growth, 2009-2014



Source: Eurostat (2015) ibuy survey

FIGURE 7. Online Purchase Activity and Growth by Retailer Category, 2009-2014

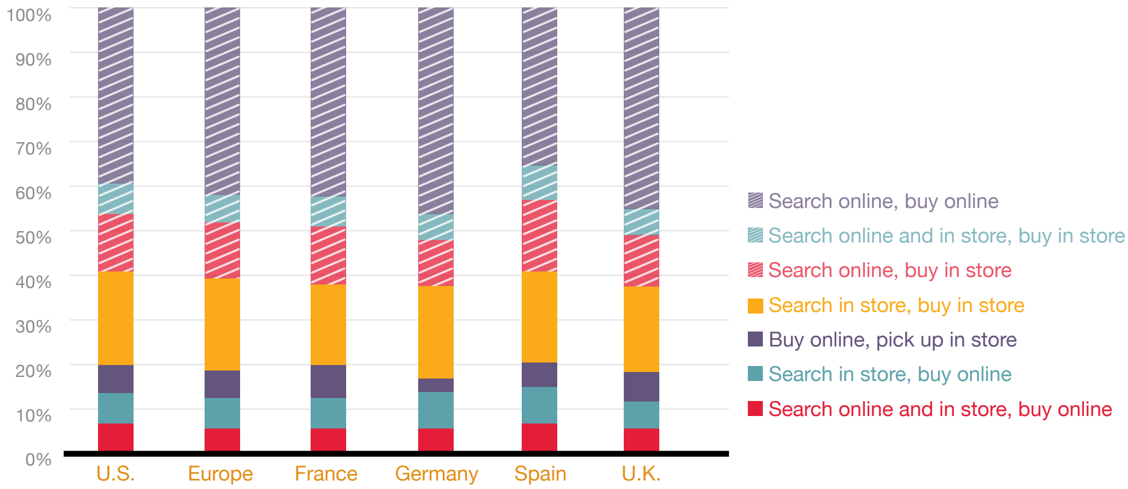


Source: Eurostat (2015) ibuy survey

Given the symbiotic relationship between online, in-store and other channels such as catalogue sales, retailers are shifting away from separate profit centres. Focusing on the final POS is misleading as it masks the more complex customer journey underlying it, involving multiple consumer touchpoints. For example, it is estimated that in the U.S. and U.K. over 50% of in-store sales are Web influenced, with consumers browsing and researching products and peer reviews prior and during a store visit.[7]

Equally, online sales are influenced by the physical store as part of the pre-purchase journey, fulfilment or post-purchase experience. This holds true for even the most digitally active consumers. A Comscore survey on behalf of UPS solely targeting very active online consumers found that the store influenced the customer journey in up to 60% of their online sales transactions (Figure 8).

FIGURE 8. Role of Store for High Frequency Online Shoppers



Source: UPS / ComScore Survey, Europe (2015); UPS / Comscore Survey US (2015). Survey of online consumers (sample of respondents comprises 20% making 2-3 purchases, 40% making 4-6 and 40% making 7+ purchases on-line in past 3 months) 'Thinking of purchases you make, both online and in stores, how often do you purchase in the following ways?'

For omni-channel retailers, what matters is that the sale occurs, that customers' experiences are positive, and that they will remain or become loyal to the brand. Customers expect a 'one-customer, one-company' service, a demand that exceeds many retailers' capabilities.

The key for retailers is not new: to deliver the right product, at the right price, in the right place, in the right way, to the right person. The difficulty is that the right place is now both more diverse and more dynamic. Most multi-channel retailers understand the importance of restructuring their business models to better meet the demands of their customers.[8]

Omni-channel shopping behaviour requires retailers to mature from multi-channel platforms to an omni-channel organisation, which requires a considerable investment in inventory management and information tracking systems.

3.0 RETAILERS' EVOLVING BUSINESS MODELS

Shopping behaviour continues to evolve as technology becomes more accessible, more pervasive, more powerful and more intuitive. Retailers are responding by restructuring their business operations to better respond to consumer demands and capitalise on technological change.

This reorganisation permeates every aspect of the business. In addition to organisational transformation, the evolving omni-channel retail model also has significant impacts upon store portfolios' optimisation and the role of the store itself.

3.1 From Multi-Channel to Omni-Channel Operations

In order to transform into an omni-channel operator, retailers must integrate all aspects of their business models. Nearly all retailers have incorporated this goal into their business plans, but few have achieved full integration at this point in time.

Central to this is the integration of teams to enable a holistic approach to understanding customers, developing the retail proposition, selecting stock, tracking inventory, merchandising and marketing strategies. This integration requires the wholesale realignment of the operating model in terms of processes and systems, teams and performance measurement, as well as the redistribution of the cost base.[9]

Traditional retailers' investments in their online platforms are placing strains on the profitability and growth demanded by public markets. As a result, only 19% of the top 250 global retailers have been able to deliver a profitable omni-channel strategy[10], when online profit margins are broken out. This confirms the assumption that most top retailers are not highly advanced in rolling out their integrated platforms.

Most retailers are still catching up, with more experimentation required. Fulfilment and inventory management, the keys to unlocking profitability, represent the top priorities for the majority of retailers, requiring considerable investment.

Integrating platforms involve three major stages:

1. **Effective inventory management and tracking.** Retailers with a large online presence may operate a complex inventory system as a legacy of having parallel online and in-store retail channels. This may include distribution from central, regional and local distribution centres and from stores. Managing this inventory requires the creation of an integrated information technology system. For many retailers, establishing a system that ensures that the retailer knows the location of all of its products on a real-time basis is something they must get right. The ability to deliver a product that is supposed to be in inventory to a customer, whether at home, in-store, in-store for pick-up, or at other distribution points must be achieved as promised and in a timely manner. Fulfiling such promises, whether made in-store or online, is essential to building customer loyalty and trust. Hence, inventory management and fulfilment are a major focus for many retailers' capital expenditures currently.

2. **Facilitating fulfilment as inexpensively as possible**. Fulfilment is a considerable cost for retailers. Amazon, the largest online retailer in the U.S. and Europe, has set the bar high with a large-scale efficient fulfilment system and an aggressive growth strategy that frequently offers free shipping.[11] Its heavy focus on distribution is allowing it to further shorten delivery times. As a result, traditional retailers feel the need to compete with their own low-cost or free shipping that is also provided quickly. Viewed by investors as 'tech' companies, Amazon and other Internet-only retailers have greater latitude in favouring growth over profits.[12] In contrast, traditional retailers are subject to meeting quarterly

profit hurdles to satisfy investors, no matter their success in growing online sales. Currently, click and collect holds little cost advantage for many retailers as online and physical stores may use separate central warehouses and inventory management systems, requiring an item to be delivered to the store regardless of whether it is in stock. According to a Boston Retail Partners December 2014 report, only 24% of retailers have systems that work well for click and collect, and 29% of retailer's systems work well for returns. Integrating inventory management alongside distribution may unlock profitability.

3. **Integrating marketing and brand experience.** Customers expect a seamless, cross-channel brand experience. Stores are integrating with all other channels and must provide uniform pricing and access to the full merchandising range and mix, product and order information and customer preferences. This is apparent in the number of retailers that have equipped sales assistants with tablets and other in-store technology to enable customers' access to the retailer's full range and inventory. An externality of this has been the blurring of lines between in-store turnover and online sales.

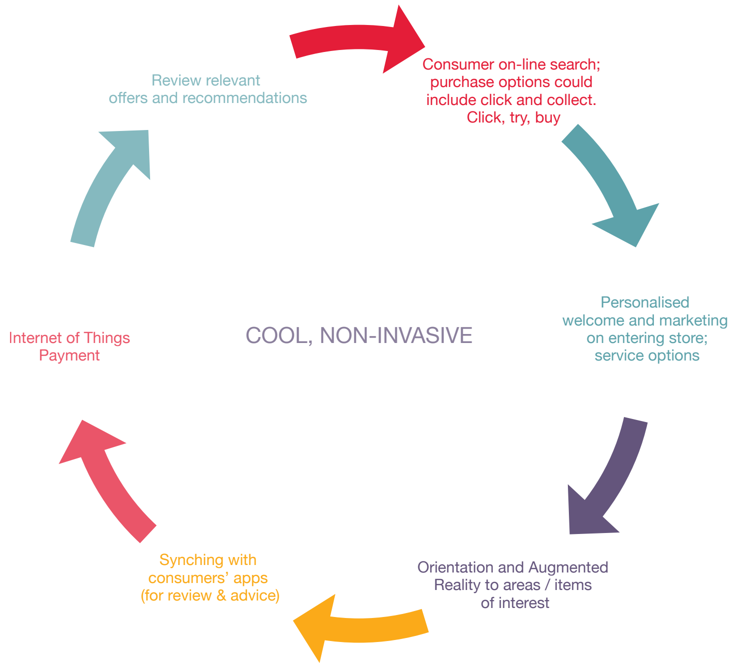
Increasingly, customers are also seeking to be able to continue their shopping journey in any place, whether online or in-store, without having to re-trace steps. This requires all applications to be integrated and to be capable of identifying individual customers across channels. The linkage of online and in-store customers may be achieved through membership of a loyalty programme by card, online or downloaded mobile app, or increasingly through an opt-in pushed to the customer through the use of Wi-Fi, GPS/mobile and beacon technology that interacts and tracks web-enabled phones. Digital storefronts and displays are linked to virtual marketing platform using QR (Quick Response) codes and RFID (Radio Frequency Identification) tagging which can inform and entertain the customer on a 24/7 basis. These applications greatly enhance marketing opportunities, with technology and sales assistants both equipped to navigate, direct and assist consumers pre-, during and post-purchase.

Combined with the emergence of payment via smartphones, these technologies also liberate the point of purchase, providing customers with the capacity to transact anywhere in the store, removing the need for fixed or mobile payment terminals. Such transactions occur directly between the customer and retailer, rather than via a store payment terminal. This trend is still in its infancy but is expected to develop quickly. Looking forward, the absence of centralised payment terminals will further reduce the owners' ability to demarcate in-store sales, although retailers would be able to track these.

Developing cross-channel customer insight is central to effective, cross-channel marketing. Figure 9 illustrates how the integration of technology across platforms could be used to greatly enhance the customer experience and increase sales. Of course, the key is to ensure that customers benefit from enhanced customer service and that strategies are not overly invasive.[13] For example, a customer's entrance may trigger a notification to the retailer. The order is retrieved, then held at a designated collection point. This efficiency greatly improves the customer experience, saving that most precious commodity, time.

Such customer insight from understanding the complexity of cross-channel shopping behaviour and how it varies by mood and mode is valuable for increasing business profitability. Most importantly, it allows retailers to clearly identify and retain the notional 20% of consumers that deliver 80% of profit.

FIGURE 9. Extension of Customer Journey



Source: Adapted from McKinsey, 'Digitizing the Consumer Decision Journey,' June 2014

To achieve this requires business accounting and profit centres to be reorganised to better reflect the omni-channel business. The customer does not care where a sale is booked, but demands excellent incentivised service at all stages of the shopping experience. Where a sale is booked is no longer an indication of all the factors that contribute to that sale. Increasingly sales are being attributed to profit centres based upon the geographical reach of stores rather than by retail channel.

3.2 Store Portfolio Optimisation

Isolating the impact of omni-channel retail strategies upon store portfolios has been difficult, as the industry has faced multiple headwinds in the aftermath of the financial crisis in both the U.S. and Europe. Over-indebted consumers focused on paying down unsecured debt and replenishing savings, and credit availability receded. Austerity measures reduced public spending, resulting in job losses. This, combined with freezes in public-sector pay levels across many markets, led to declining income in real terms. This was exacerbated by sharply declining house prices in markets where personal gains in wealth from a pre-crisis house price boom had helped to fuel retail spending, most notably in the U.S., the U.K., Spain, Ireland and Portugal. Retail spending declined and refocused on value, with discount retailers and expanding non-food segments of supermarket retailers being the primary beneficiaries.

The growth of multi-channel retailing over this period provided retailers with the opportunity to reduce their fixed costs by rationalising their store portfolios to stem dwindling profit margins. In some locations this has resulted in some secondary retail locations being perceived as obsolete, while in many, rental levels have been rebased to more sustainable levels in line with retailer affordability. The resulting weakness of consumer demand, together with over-leveraged retailer business models, left the sector exposed. Consequently, vacancy rates increased in secondary centres in Spain and in non-prime high streets in the U.K. In the U.S., there is a well-established understanding that lower-quality retail space may need to be repurposed, renovated, or redeveloped. Similar trends apply for open-air centres, particularly those located on the urban periphery.

This has led to retailer and investor retrenchment to prime locations, destination shopping schemes and retail centres that dominate their catchment area. The continued growth of online retailing over the same period exacerbated the impact of declining in-store spending patterns and facilitated structural change.

However, one of the principal drivers of retail decline was the inability of over-indebted and over-expanded retailers to withstand sharply deteriorating retail spending patterns. Online retailing aggravated rather than caused the downward retail spiral in secondary locations and centres in the U.S., Southern Europe and the U.K.

That experience differs from the Nordic markets, where online retail is a relatively mature sector, having first emerged in the late 1990s. Between year-end 2007 and year-end 2012, Sweden experienced 5.6% in compound annual growth rate (CAGR) in nominal online sales, over twice the CAGR for all retail sales even in nominal terms.[14]

Over the same period, retailer demand strengthened and the requirement to rebase rents in line with affordability prevalent across many European markets did not arise. Indeed, prime high street and shopping centre rental levels increased by 7.0% since the previous market peak in 2007; growth in secondary shopping centre rental levels has been marginally stronger at 7.5%. The market experienced a short and less severe economic downturn.

Put simply, retailers have found it easier to get a smaller piece of a bigger cake in Sweden than to get a bigger piece of a smaller cake in the U.S. and other European markets such as the U.K.

Nevertheless, as omni-channel retail continues to evolve, the structure of the retail landscape will adapt and respond.

Nevertheless, as omni-channel retail continues to evolve, the structure of the retail landscape will adapt and respond. Retailers are merging their physical and online platforms to increase total sales, lower costs and improve service levels to customers. Increasing sophistication in personal online marketing and delivery channels also enables retailers to reach their customer base with a reduced physical store portfolio.

Retailers have shifted store expansion strategies to conquering principal cities, rather than countries, reflecting the greater marketing reach of flagship and major stores.[15] The size of appropriate store portfolios will vary according to the scale of the market and the characteristics of the retailer with regard to sector and target audience.

Aspirational retailers may seek to constrain store portfolios to help protect and extend the scarcity or 'wow' value associated with the brand. At the same time, the provision of omni-channel enables flagship and major stores to have a much deeper reach and sphere of influence than previously achievable. Other retailers may require a larger store portfolio, but they are changing the strategy on the size and number of stores required. For some retailers, this may manifest itself in a reduced store portfolio by number of stores and reduction in store size in secondary locations, balanced with increased larger flagship stores.

The larger stores enable the retailer to showcase products and focus on engaging consumers through excellent customer service and brand experience. For others, the opposite may be true, as size was reduced but the number of stores was increased, providing more physical touchpoints to engage with consumers. Moreover, many retailers are creating a more defined store hierarchy within their portfolios, demarcated by the function or purpose of outlets in different types of locations.

Since the onset of the downturn, retailers have largely pursued polarised store portfolio strategies. Securing good quality space in perceived 'A' locations, including large, destination shopping centres and prime high streets in Europe and upscale streetfront retail in the U.S., was the principal objective. Such locations provided the required critical mass of co-located appropriate retailers, quality of environment and the required access to a consumer audience at a required scale and quality.

Demand for what remains a finite number of locations has exceeded supply, and rents for such space have increased. The use of this space is multi-faceted. In addition to driving store sales, retailers are keen to use this high-profile space to build brands through showcasing products to engage with their consumers in a face-to-face interaction, providing excellent customer service and complementary services to customers. Expensive store fit-outs are a central part of this retail theatre and brand building. As a result, retailers report that on a store sales basis, profit margins are under pressure, despite strong top-line sales.

However, the stores are an important driver of sales across the wider store hierarchy and also online. As the recovery in most regional economies gains traction, some retailers are beginning to cautiously expand into good-quality, but lower-cost 'B' locations that are able to feed off flagship and major stores and assist in driving profitability. Unlike 'A' locations, what constitutes a 'B' location is much more variable across retailers given differences in product range, target audience and pricing strategies. As a result the cost of space in these locations is under considerably less pressure, allowing for higher profit margins for retailers who perform well in such centres. In addition, excess space in these stores can provide localised fulfilment opportunities.

Store portfolios have also placed a secondary focus on properties that provide or facilitate brand awareness, convenience and impulse purchases. Importantly, these stores offer an easy access point for consumers to interact with the brand, retrieve knowledge and serve as a collection and/or return-of-goods point bought online. Again, the focus is on exceptional customer service, with an emphasis on convenience to maximise the utility of a consumer's time.

3.3 Purpose and Value of the Store

Most retailers now realise that the physical store is the cornerstone of their overall omni-channel retail operation.

The extension and greater complexity of consumer journeys characterising omni-channel shopping behaviour have increased, rather than diminished the role of physical stores. Most retailers now realise that the physical store is the cornerstone of their overall omni-channel retail operation. The value to the business is now considerably more complex than a mere POS. Strong synergies between sales channels have been evidenced by increased online sales in markets where the retailer opens a store. Long valued by luxury fashion retailers, the physical store is now also viewed by even mid-market retailers as a key to branding and showcasing products. This space must be experiential in a way that establishes the image and brand of the retailer, while also showcasing its products in a way that drives sales. Whether the sale then occurs at the register, as an online sale picked up in the store (click and collect), as a subsequent online sale, as an in-store online sale through a smartphone, tablet or kiosk, or as a return/exchange of an online purchase does not matter to the modern retailer. The store also provides a 'halo effect' in the locality, creating brand awareness from its presence that can positively impact online sales.

The retailer's objective is to drive sales, while establishing customer loyalty and branding for long-term success. At its extreme, certain retailers have retained seemingly non-performing stores because of their importance and synergistic relationship with online sales volumes in the catchment area. A number of studies have indicated that online and in-store sales benefit cumulatively from an integrated operation.[16] Recognising this, many pure-play retailers have and are opening physical stores to enhance their brand.[17]

4.0 SHOPPING CENTRE OWNERS' EVOLVING BUSINESS MODELS

The major shopping centre owners in Europe and the U.S. have also fundamentally restructured their businesses to meet the needs of their customers—both retailers and consumers. The speed of change is impressive. Given that retail and technological change remain dynamic, owners remain agile. There are three principal areas of business restructuring and development for these owners: portfolio specialisation, place-making and digitising the business model.

4.1 Portfolio Specialisation

Mirroring retailers, the demand for shopping centre investments has polarised between large, destination centres and, neighbourhood and convenience centres. In the U.S., demand is also strong for both types of centres, although investors segment these types. Demand is somewhat different, however, for secondary centres and secondary locations with weak performance. While retailers have developed stratified portfolios, owners have rationalised portfolios and tended to specialise in a particular segment of the retail hierarchy. In the U.S. and Europe, the largest public REITs and large institutional investors have focused on prime assets and have been culling weaker performers.

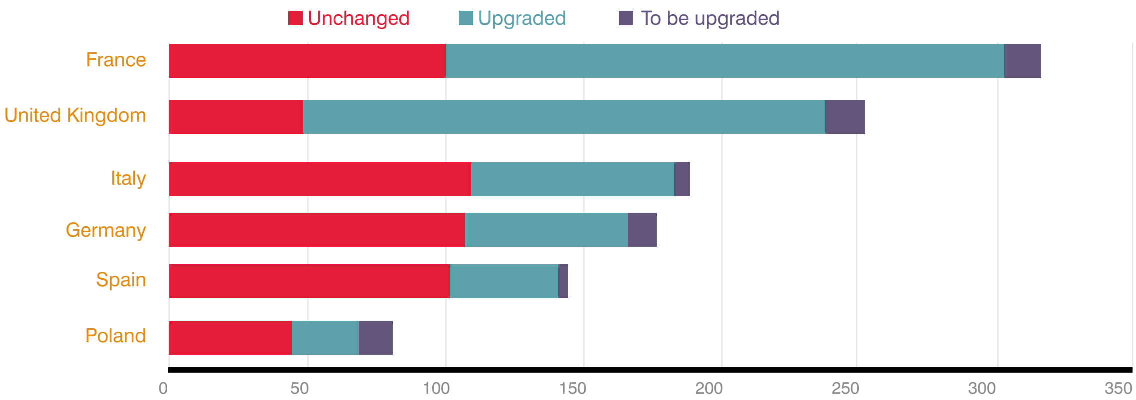
In both the U.S. and Europe, dominant destination centres are particularly favoured by the largest shopping centre owners and investors. In both regions the ownership of destination and experience centres is becoming increasingly concentrated due to mergers and acquisitions among private and public property companies, investment firms as well as aggressive property acquisitions. These high-quality assets draw from a substantial affluent population and have benefitted from strong retailer demand.

Such owners specialise in destination retail and engaging consumers with stimulating environments and experiences, supported by outstanding customer service and facilities that maximise the utility and quality of time. In managing these capital-intensive properties, owners are increasingly establishing a recognised brand of ownership for the centre through more extensive marketing efforts than were the norm in the past. Some owners are carrying this branding even further, establishing a national or global brand for their portfolio of properties.

A second group of owners specialising in convenience and neighbourhood schemes is identifiable. These centres may be small enclosed malls (more common in Europe) that are dominant and well-located in their catchment or accessible open-air formats that again seek to maximise the utility of time for consumers through ensuring that the experience of fulfiling consumer needs and requirements is convenient, easy and supported by excellent service. This includes the co-location of appropriate services. Stronger centres are typically owned by public and private companies quite separate from the large destination centre owners and by other institutional investors.

Beyond the spectrum of experience and convenience, retailer demand for mid-sized centres in Europe has been considerably lower. The impact on pricing has resulted in low capital investment for many such schemes. In the European context, Property Management Analysis (PMA), a supplier of real estate data and analysis for the region, has referred to this cohort as the 'squeezed middle.' (See Figure 10.) While some weak schemes in competitive catchments may be challenged, other centres in stronger catchments that benefit from a more dominant position may simply require re-positioning within the new retail hierarchy.

FIGURE 10. 'Squeezed Middle' Schemes Built Pre-2005 By Refurbishment / Redevelopment Status



Source: Property Market Analysis (PMA) (2015)

4.2 Shift from Space-Making to Place-Making Strategies

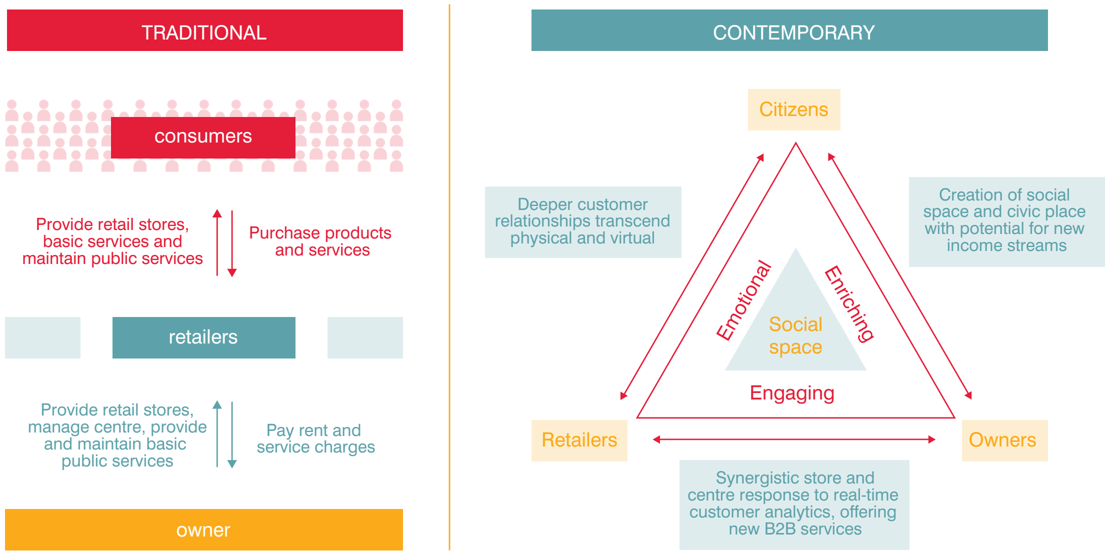
Many owners recognised by the late 1990s that retail environments needed to provide consumers with an experience that greatly transcended transaction activity. In the U.S., this was prompted by above-average supply in some areas, renewed interest in high streets or downtowns, and the emergence of lifestyle centres. In Europe, it was initially prompted by a socio-cultural consumer shift from 'need' to 'want' and the appreciation of the value of time. The evolution of multi-, and later omni-channel retail further accelerates this shift. It also made such change even more imperative in the U.S.

In such environments, shopping has become not merely a means to an end, but an activity to be enjoyed in and of itself, regardless of the outcome. Shopping centre owners have followed the lead of successful retailers, who inspired by Apple, have used their stores as places to entice, excite and connect with consumers. As a result, owners have shifted focus towards creating a unique sense of place and social space that stimulates all five senses. This has major ramifications for shopping centre design, including the scale and function of public spaces.

Customers are drawn to a retail destination by the social activities, 'edutainment,' leisure pursuits and related events that it offers as much as by the presence of retailers. This transforms the role of the shopping place from a fairly passive physical entity to an active, civic entity with a sense of place distinct from what is offered by retailers. Retailers will need owners to create the market-place at least as much as owners need them. By creating a shopping place, not merely shopping space, the owner has the opportunity to harness the brand value created.

This is a significant shift in the traditional roles of owners and retailers. Formerly, the shopping centre owner provided a well-located and -designed venue for appropriate retailers. The owner managed the tenant mix to drive consumer footfall and sales. Management focused on understanding the agglomeration economics of co-tenancies in order to maximise the power of the tenant mix. Aside from advertising campaigns and perhaps consumer research, the owner's relationship with the consumer was indirect, with retailers being responsible for directly engaging consumers (Figure 11).

FIGURE 11. Traditional Shopping Centre Model



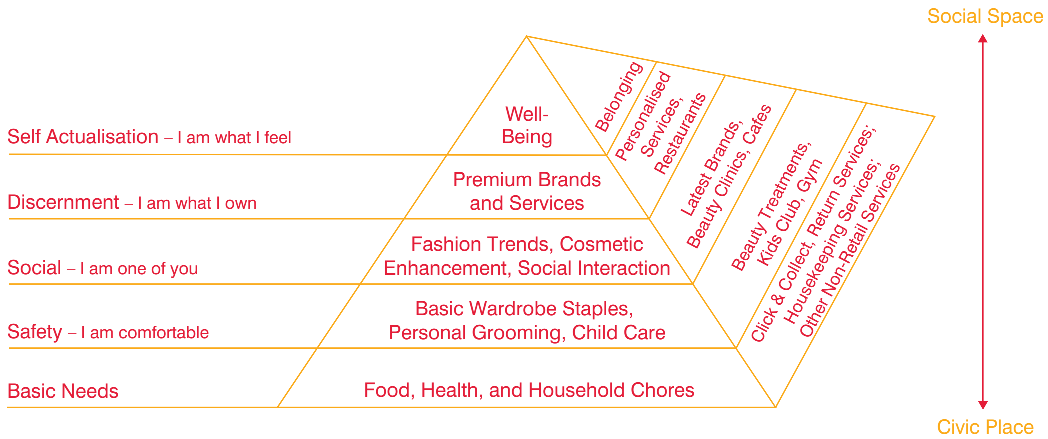
Sources: RHL Strategic Solutions (2010); Milligan Retail (2010)

In a transfer of responsibility from retailer to landlord, owners are directly engaging consumers through place-making strategies that help to drive customer flow to retailers. Owners seek to draw their target audience to the location along the continuum between civic place and social space. The creation of a 'civic place' enables retail to be better connected to broader economic and societal pursuits. Although a sense of 'social space' is also important for convenience strategies, it will dominate experience- and leisure-orientated retailing. Feelings of ownership and belonging are encouraged through spaces and services that, by enhancing consumers' well-being, allow them to transcend their purchase decision and facilitate discretionary spending. In both cases, the environment will foster a sense of community cohesion. Doing so will require owners to deliver tangible added value for their shoppers.

Related to this, for many consumers, time is their most valuable resource. Co-locating and delivering services and/or experiences that maximise time will underpin customer experience. Strategies, again, will differ across different centre types and customer profiles. For example, convenience-led centres may co-locate civic or other non-retail services within a non-core retail space in the centre, reducing the time that customers require to undertake chores, as well as placing retail near where consumers have to be. Equally, leisure-based shopping centres will need to provide the consumer with an experience that can deliver more than competing leisure pursuits. This requires the provision and co-location of services that add to the customer's sense of well-being and happiness (for example, personalised services, centralised collection points for shopping, etc.). Figure 12 attempts to depict this evolving state of affairs.

Leasing strategies also identify and court retail brands that have a significant impact on footfall (including to other retailers). This creates a hierarchy of cooperative, collaborative and co-dependent relationships between owners and different types of retailers, and among retailers themselves.

FIGURE 12. Social Space and Civic Place



Sources RHL Strategic Solutions (2010); Milligan Retail (2010)

Whilst once concentrating on providing retailers with an excellent space in a great location with superb co-tenancies, today's owners increasingly create a venue that attracts consumers and enables the retailer to fully establish its brand. Progressive owners and managers are adept at harnessing technology to facilitate their objectives.

4.3 Digitising the Business Model

The evolution of the role of technology within shopping centre owner business models mirrors that of retailers. Initially set up as a stand-alone department, usually within the marketing department, digital is now fully integrated into every area of the business. Digital runs through the DNA of re-fashioned business models and its role and importance may be summarised in four inter-related objectives:

4.3.1 Customer Experience

Most owners have initially focused digital strategies on developing applications and services that greatly enhance the customer experience. These might include a shopping centre app, with or without an associated loyalty scheme. The aim of such applications is to create a customer experience that is engaging, easy and convenient. (For example, way-finding apps and/or augmented reality provide autonomous way-finding for consumers.)

Equally, the ability to locate a vehicle within the car park on an interactive map and/or pay for parking by mobile device enhances the customer journey. The appropriate provision of smart retail walls and/or installation of interactive walls and magic mirrors within the mall or within certain stores, may also enhance the customer experience by maximising time.

4.3.2 Enhance Sales

Shopping centre apps that provide customers with readily accessible information have been quickly recognised as an important sales-driving tool—for example, by rewarding customers with a free additional hour of parking or with a coupon for a refreshment. Similarly, dwell time can be extended through retailers, who can collaborate with owners to distribute vouchers or push a marketing promotion. Most owners stress the importance of giving the consumer autonomy in the selection of offers they are willing to receive so that they are not overwhelmed by communications.

4.3.3 Customer Insight

Owners are experimenting and investing in new technologies and services that will help them to better understand their customers' value and anticipate their wants and needs. Traditional methods of research have not been abandoned, but their limitations are becoming more apparent. These tools have typically been customer counters at major centre entrances, at entries to stores, in hotspots within centres, intercept interviews and focus group sessions. Established systems for counting shoppers at entries have numerous accuracy problems.[18] Most counters provide no information on the quality of shoppers, their travel patterns or dwell time. Intercept interviews and focus group sessions can provide considerably more information on shopper identity and patterns, but are expensive and conducted infrequently. In addition, they tend to overweight shoppers with time on their hands.

Digital solutions are now being examined to build upon these traditional research tools. Mirroring retailer strategies, innovative owners are tracking consumers using a variety of techniques including *Wi-Fi, beacons*, and *GPS/mobile devices* (cell towers).[19] Thus far, the various technologies all have limitations regarding the information gathered as this industry of vendors is still in its infancy. However, the range of digital solutions, as well as the coverage, accuracy, sophistication and capability of existing applications, is expanding rapidly.

Wi-Fi tracking is used to track customer flow and generate heat maps in real time across the centre. Being linked to an individual's web-enabled phone also allows dwell times to be calculated and is particularly useful for understanding the contribution and peel off rates of anchor stores and other major retailers to the centre. A limitation of the technology at this point is that it is only accurate within a 7-metre/22-foot range, which means data on customer journeys and peel-off rates from the customer flow of one retailer to other retailers in the centre is not granular.

Beacons provide greater accuracy. Initially quite expensive, the technology is becoming increasingly cost effective. Depending on the configuration of the beacons, these devices are capable of tracking a web-enabled phone regardless of whether Wi-Fi is turned on. The greater tracking accuracy allows for the relationships between retailers to be analysed and measured, with the net contribution of individual retailers to customer flow being quantifiable. This allows owners to identify those retailers that really add value to a centre and those that benefit from it. Generally in the U.S., shoppers are not automatically tracked and the legal perspective can vary across states, with digital tracking requiring customers to opt-in. (The same situation can be observed between countries in Europe.) This could include the shopper downloading the retailer's or shopping centre owner's app.

Each mobile device has a unique IP number which allows owners to identify customer retention/loyalty rates, frequency of visits and, where relevant, whether they shop at other destinations within the owner's portfolio. Tracking can explain movement, but provides no information about customers or their spending patterns. Where customers with smartphones opt-in to a shopping centre system, perhaps by accepting free Wi-Fi, or downloading an app or other offer (such as agreeing to be part of a VIP club), owners are able to gain further customer insight by asking for personal information on a 'give to get' basis. These beacon captures allow an owner to develop a much better understanding of consumers and their interaction with the centre, and start to identify a precise consumer cohort to target.

GPS/mobile technologies provide much the same information as Wi-Fi but can track shopper demographics on an aggregate basis. However, most vendors rely on only one telecom service for this tracking and, therefore, cover only a portion of shoppers. In addition to capturing consumer flow within a centre from triangulation of devices with cell towers, additional information as to where consumers work, live and where else they might shop can be provided at an aggregate level. This assists in developing socio-demographic customer insights.

The perceived value of these platforms has always been less about the sales volumes generated and more about their marketing value.

Website capabilities developed by a few owners allow smaller retailers cost-effective access to a transactional online marketplace, and provide consumers with access to stores within the centres on a 24/7 basis.[20]

The perceived value of these platforms has always been less about the sales volumes generated and more about their marketing value. First, owners develop very valuable operational knowledge of and expertise in both online enterprise and customer relationship marketing. Second, when a portfolio is relatively homogeneous in scale and positioning, a company can more easily build a consumer brand with appeal across all its centres.

However, emerging tracking technologies greatly increase the value of transactional websites to owners, by furthering the understanding of the omni-channel behaviour of customers and most importantly, their spending patterns. Linking this to shopping centre tracking data allows owners—like retailers—to begin to identify the notional 20% of consumers that generate 80% of profit.

4.3.4 Retailer Relationships and Revenues

The customer insight derived is also valuable to retailers within the centre and those considering opening a store. Most owners are using their analysis to strengthen relationships with retailers, and as a tool to explain and support asset management initiatives. Understanding synergies with other retailers and their relative performance within the centre is valuable knowledge to the owner. A number of owners will collaborate with retailers and develop marketing plans, including digital strategies, to remedy challenges. Currently, most owners do not charge for this service. However, some are beginning to capitalise on their knowledge base, customer engagement and marketing expertise and are developing value-added customer insight and marketing services for retailers. Such services provide a new revenue stream and the capability lowers the risk and heightens the brand value of the centre.

5.0 CHANGING LEASE STRATEGIES

Throughout Europe and the U.S., macro trends, including and facilitated by technological change, are transforming the shopping centre industry. The creation of place has usurped the development of space for both owners and retailers. The transformation of retailing from multi- to omni-channel has made this change even more urgent. This shift in emphasis is also changing the structure of lease strategies in regard to tenant mix, lease length and income security, and in the development of services and new revenue streams.

5.1 Tenant Mix

Shopping centre owners and managers interviewed explained that omni-channel retail, in conjunction with wider structural change, is having a significant impact on tenant mix strategies. Such change is evident across all centres, although the implications for tenant mix vary with the type of centre. Although these changes are neither recent nor solely driven by technological change, the growth of omni-channel retailing is accelerating the trend.

All markets report a sharp increase in F&B as a proportion of gross leasable area (GLA) in centres. The proportion of GLA dedicated to this use in European shopping centres has already increased from 11% to 15%, with new developments and refurbishments indicating a further rise to 20%. In the U.S., higher-quality malls and lifestyle centres are at the higher end of this range and open-air centres at the lower end, and both are growing. This increasing allocation of space to F&B is very important to destination and experience centres. Until relatively recently, the role of F&B within a shopping centre was to assist in extending dwell time by enabling consumers to rest, re-fuel and re-charge. Currently, the F&B offer is being used as a major driver of footfall to destination and experience centres. As a consequence, it is not merely the quantity of space that has altered, but also the range and higher quality of operators.

Shopping centre owners and managers are enhancing the F&B component of the centre to build brand and engage target consumers. Traditional food courts are being replaced or supplemented with high quality fast casual, market hall and upscale full-service local and regional operators. There has been a general shift in leading edge centres away from generic national to more local and 'authentic' outlets. Although F&B operators prefer longer-term leases ranging from 10 to 15 years, a number of owners indicated that they are retaining a small proportion of F&B space on short-term leases to provide a more dynamic offer that keeps the centre's consumer appeal fresh.

Specialty leasing has become a much more prominent component of a centre's leasing strategy than in the past.

Specialty leasing has become a much more prominent component of a centre's leasing strategy than in the past. Historically, its focus was on carts and finding temporary or seasonal retailers to fill otherwise vacant space. Today, it is becoming a more central strategy to attract unique, start-up, alternative or 'pop-up' retailers (and sometimes branded retailers) as part of its directive to improve net operating income and merchandising variety through fee-based, short-term licensing of space within the shopping centre.

While owners are generally launching this innovative retailer strategy, third-party intermediaries are also emerging, such as Appear Here in Europe and Storefront in the U.S. Both companies provide innovative solutions for retail space, providing start-up concepts and pop-up stores. Some owners have also created co-working space within the centre, renting small work areas and conference rooms to businesses (including retailers, entrepreneurs and start-ups), further establishing a sense of place. This is also an opportunity to nurture the retailers of the future.

In all cases of specialty leasing, a more contemporary view is being understood of the worth of retail space, recognising the inherent value of the advertising billboard it represents and how this consumer interface opportunity compares to brand-building space elsewhere, including online.

A unique and experiential strategy is also evident within overall retail mix strategies, with owners adopting more dynamic leasing strategies. Even in expensive high-quality centres, owners are devoting a small but significant percentage of space towards embryonic retailers, including new and test concepts from major national and international brands, local established independent retailers and/or pop-up or start-up shops with a viable and scalable business plan. Pop-up shops are used to complement rather than compete with existing retailers and can provide a central attraction upon which wider retailer and centre marketing strategies can anchor to further enhance appeal.

Within European convenience and neighbourhood centres, highly regarded local provenance retailers are beneficial to customer flow and to increasing customer engagement.

Within European convenience and neighbourhood centres, highly regarded local provenance retailers are beneficial to customer flow and to increasing customer engagement. Pop-up shops from aspirational or innovative brands also provide the opportunity to create events that may be tied into wider local and / or regional initiatives. In the U.S., neighbourhood and community retailer centres are generally anchored by a major national or regional grocer, while the shop space has long been dominated by local retailers who target local needs. In response to this local demand, an increasing allocation is being made to F&B tenants.

In both Europe and the U.S., destination and experience centres are also increasing allocations to leisure and entertainment. Attractions, including pop-up varieties, are being used to drive footfall and extend dwell time. Similarly, certain specialist retailers that have a strong brand and innovative entertaining store concept, yet low affordability, are also recognised as providing a valuable point of difference for competing centres. Although the affordable rent level of such stores may be low, their positive contribution to customer flow as a leisure attraction in addition to being a retailer is recognised.

The provision of more favourable lease terms for retailers that generate very strong consumer footfall is not new. A number of owners commented that the variation in rental agreements according to brand strength is increasing.

However, the increased sophistication of consumer tracking within centres is also improving owners' understanding of the contribution of individual retailers to the centre. Owners and consultants commented that a number of retailers that benefit from attractive lease terms do attract strong footfall to their stores, but customer analytics suggest that there is little evidence of synergy with other retailers across the shopping centre. More granular analysis of customer flows allows owners to better understand the synergistic value that individual retailers bring to a centre in addition to their analysis of direct sales.

Place-making is at the heart of re-engineered shopping centre strategies and owners are integrating services into the tenant mix to deliver on experience and convenience.

Place-making is at the heart of re-engineered shopping centre strategies and owners are integrating services into the tenant mix to deliver on experience and convenience. In destination centres this often includes the co-location of gymnasiums, spas, medical clinics and non-surgical cosmetic clinics as well as customer services such as collection lockers or centralised shopping services that are used to help customers maximise the quantity and quality of time.

In the U.S., owners of open-air centres are also adding amenities including gathering areas, increasing F&B including popular fast casual dining, coffee bars, fitness centres, and unique and interesting retailers. In some cases, fashion retailers who traditionally locate in malls can be attracted. In the U.S., power centres/bulky goods retail parks, which historically have been a functional gathering of discount retailers, are in some cases being supplemented with a lifestyle component and/or grocery store. The lifestyle component has a pleasant pedestrian gathering area surrounded by F&B, cinema, apparel and other specialty retailers.

In European convenience and neighbourhood centres and in U.S. neighbourhood and community centres, services are a rising proportion of the retail mix, including opticians, dentists, dry cleaners, medical clinics and personal grooming/beauty clinics. In addition, a number of owners are experimenting with the co-location of public services as a means of placing the shopping centre at the heart of the civic centre or community. For example, the co-location of major medical health facilities, government offices, adult education or public libraries is being tried.

Again, these services assist in driving footfall and simplifying customers' daily lives. Through co-location of services, convenience retail can help to create time efficiencies for consumers, thereby releasing a prized commodity for customers.

More challenged larger neighbourhood centres in Europe are also experimenting with innovative retail and management concepts. For example, new retail concepts such as Internet stores offer a limited product inventory in terms of size, colours and range, but allow consumers to experience the product and gain advice before purchasing online from facilities within the store, for store delivery. Other innovations include the provision of a grocery anchor or department store by way of an Internet wall, with associated space for marketing and fulfilment.

5.2 Lease Length, Security of Income and Security of Tenure

Lease structures are quite different in the U.S. and Europe and are therefore discussed separately.

5.2.1 U.S. Lease Structure

Lease structures have evolved relatively little in the U.S. over the past decade or more. Strong anchor or junior anchor retailers generally negotiate 10-year leases with options to renew that can extend to 30 years or more. A retailer in a strong bargaining position will be able to obtain options to renew at a fixed rate, based upon periodic inflationary bumps. An owner in a relatively strong negotiating position can resist such fixed options.

The majority of tenants seek 5-to-10-year leases in major destination centres, with inflationary adjustments over the lease period, sometimes with options to renew. A percentage or overage rent is added to the base rate so that the owner can capture better-than-expected performance from the retailer. The term is largely dictated by the cost of tenant build-out, which is usually shared by the retailer and owner, and is needed for amortisation.

Since build-outs have been increasingly costly as retailers establish their brand identity and provide an experience, there has been little pressure from retailers to shorten the lease. However, if they have a negotiating advantage over the owner, particularly in an unproven location, the retailer may successfully get a 'kick-out' clause, allowing them to vacate if their sales volume does not reach a specified level by a target date or if appropriate co-tenancies are not maintained.

When an owner is taking a chance on a new retailer or one with poor credit, shorter-term leases are common. As a result, tenant build-out is as minimal as possible. In neighbourhood or community retail centres where small local retailers are common, lease terms are typically three to five years, with longer terms for national and anchor tenants.

5.2.2 European Lease Structure

In European markets, lease lengths have been trending ever shorter, at least in respect of security of income. In markets where the lease length is not prescribed in law, the term will be the product of a negotiated market contract that is driven by the underlying strength of demand and supply. This trend will differ across markets, between centres and temporally. In most European markets, retailers have a right to renew their lease on the same terms, although in certain markets it is possible to contract out of such rights.

Currently, retailers are generally seeking a 10-year lease with the benefit of a one-way break option at year five, unless the prevailing landlord and tenant law in a country is more favourable as for example in France, where tenants may break every three years. F&B operators break this trend and are seeking to lengthen leases to a minimum of 10 years, up to 15. This reflects the high ratio of fit-out costs to turnover, which requires amortisation over a longer period of time. Major retailers usually amortise their fit-out costs over a 7-to- 10-year period. Given this, some owners consider the requirement for an earlier lease break, which has a disproportionate impact on a centre's security of income profile, to be somewhat gratuitous.

However, retailers explained that the pace of retail change required greater business agility and this is accentuated where they are unable to project the cost of stores with any certainty beyond the initial term. For example, rents may be subject to review to open-market rent, rather than a stepped index-linked rise.

The greatest impact of the digital era for retailers has been on pricing transparency, giving shoppers easy access to competitive pricing information. This has squeezed margins for many retailers. Rental affordability is more sensitive to rising costs and/or declining sales. A number of retailers said that they were prepared to compensate for the additional income risk generated by break clauses. Alternatively, having greater certainty, by way of capped service charges and/or stepped rental increases, would reduce the need for a break option. Similarly, a number of retailers also suggested that having a higher component of variable rent and lower base rent would share the risk of any weaker-than-expected performance in regard to a newly opening centre.

Owners provided a different perspective, arguing that the capital costs and funding requirements of development and refurbishment are upfront commitments. They suggest that five-year leases are too short, given that financing risks are underwritten by the income security provided by retail leases. A real estate funder suggested that prevailing loan-to-value and required debt-service coverage ratios allow for a marginally higher proportion of variable income without impacting financing.

A number of owners of experiential schemes commented that they would welcome shorter leases for a proportion of the tenant mix if the ability to terminate the lease were two-way. They argued that they require greater agility to effectively manage the tenant mix in a fast-paced retail world, characterised by fickle consumers and ever-shorter brand lifecycles.

Indeed, a number of owners are viewing the income profile of the centre as a portfolio and are keen to optimise risk against retaining operational flexibility. They balance the longer security of F&B retailers and the mid-term security of major sub-anchors against the shorter lease profile of more emergent or shorter lifecycle retailers, but this operational flexibility requires retailers to forego security of tenure.

Discussions with retailers indicate that they are generally reluctant to relinquish security of tenure in its entirety. However, most retailers would consider linking lease renewal to a performance benchmark, as is the case for factory outlet centres in Europe, particularly if the variable income component of rental models were greater. A number of retailers commented that in certain circumstances, the centre and the retailers it accommodates would benefit from the ability to terminate a poorly performing retailer in an otherwise strong property.

However, most retailers would consider linking lease renewal to a performance benchmark, as is the case for factory outlet centres in Europe, particularly if the variable income component of rental models were greater.

5.3 New Services and Revenue Streams

Most owners in the U.S. and Europe are developing new services for both retailers, who remain their primary customers, as well as for consumers, in order to adapt to the changing requirements of an omni-channel era. These services may be broken down into three areas: those which facilitate fulfilment; those which greatly enhance the customer experience; and those that leverage digital infrastructure to greatly enhance customer insight. Each has the capacity to generate additional income streams for owners.

Fulfilment of digital retail presents opportunities for a range of new services. Owners are considering or are providing click-and-collect lockers and/or centralised fulfilment locations in the shopping centre. These services can provide an additional revenue stream. Some owners have also recognised that some retailers require greater storage/logistics space and are creating such space in otherwise underutilised areas of the asset. As well as creating a new revenue stream, the creation of such facilities reduces the risk of retailers expanding stock rooms at the expense of sales space within the store, thereby protecting the asset's value.

Some owners are enhancing the experience for the customer by developing a digital marketplace for retailers as a transactional website, through sales promotions and push-and-pull marketing delivered through a dedicated app. The sale of goods through websites provides a click-through sales revenue and some owners are seeking the same for sales achieved through marketing promotions on other devices. This is occurring at a point when some consumers are overwhelmed by the expanding number of apps on their smartphones. A single app promoted by the shopping centre helps customers to curate and manage multiple retail interfaces more easily. Most owners stressed the importance of designing shopping centre apps that give consumers the autonomy to select which retailers they wish to engage with and what type of communication and offers they are interested in receiving.

Owners are leveraging their investments in digital infrastructure to develop more sophisticated consumer analytics.

Owners are leveraging their investments in digital infrastructure to develop more sophisticated consumer analytics. Most owners are at the early stages of harnessing their data and are primarily using it to develop new performance benchmarks for individual centres and across portfolios to inform their own decision-making and asset strategy. Where relevant, performance benchmarks are shared with retailers in an effort to assist their understanding of the customer opportunity, their relative performance, and to improve future sales performance.

Currently, owners deliver baseline analytics as part of their own customer service, but there is also the potential to develop revenues from additional research and marketing services stemming from customer insight capabilities for existing tenants, potential tenants and, complementary businesses and services. To date, most owners limit commercialisation of their customer insight and digital infrastructure to digital advertising media, which can respond dynamically in real time to the customer opportunity.

6.0 RENTAL CAPTURE

As mentioned earlier, both owners and retailers throughout the U.S. and Europe are being challenged to better understand the value of store space given that the traditional metric, in-store sales, is no longer an accurate proxy of a location's productivity. Given that consumers use multiple touchpoints in their shopping journey and that sales occur across channels, this issue is of increasing importance.

6.1 Negotiating Process

Estimates of a store's rental value within shopping centres are still predominately based on traditional approaches. Retailers determine an affordable rent based upon the residual of their sales projections for the store, less operating costs and a target profit margin. This leaves a residual that they believe they can afford to pay for rent. Store sales estimates are based on an assessment of the value of the customer opportunity using proprietary customer insights and store catchment analyses.

The owner and/or its leasing managers will identify several retailers that they believe would best benefit from a particular location. For existing centres, leasing managers will understand the performance of comparable retailers within the centre and in other centres for which they have lease information. In addition, they will derive the rent-to-sales ratios of the target retailers in similar centres and also understand the occupancy costs (rent plus pass-through expenses and amortised tenant improvement costs) this category of retailer can bear.

Lease negotiations are likely to be based on these assessments, with the owner also considering the value of the retailer to growing the wider centre's market share of spending in the catchment. Equally, retailers will consider competitive centres as well as any potential sales cannibalisation of their existing stores. Negotiations proceed from these factors. The evolution of omni-channel retailing is placing considerable stress on this model.

Looking forward, rent models and performance metrics will evolve to capture the rental value of stores more effectively.

In the emerging omni-channel world, retailers will need to determine the rent that a space justifies, based on understanding the store's overall contribution to the bottom line. This should include both in-store sales and the contribution of the store to online sales. This is important in determining supportable rent at a highly competitive location.

Owners and leasing managers are suffering from an absence of important information regarding the contribution of the store to non-store sales, which would help them assess the true value of a retail space. Looking forward, rent models and performance metrics will evolve to capture the rental value of stores more effectively. This evolution may be supported by new metrics of customers' shopping behaviour, as the accuracy and capability of digital solutions increase.

6.2 Current Rent Models

While conventions vary between and across countries, rental models for capturing the value of a store have remained broadly unchanged since the advent of the digital era. Internationally, a base rent is the primary component of rental income. In both the U.S. and continental Europe, an additional variable rent, based upon a retailer achieving a certain sales threshold, is added. This is generally known as *turnover, overage* or *percentage* rents.

These performance-related income streams may be capped and thresholds are often revised in line with any adjustments to base rents, which are often indexed to an inflation-based metric. Typically for major shopping centre companies, these top-off rents range from 0 to 10% percent of base rents across portfolios, although there can be significant differences between centres and across lease agreements. While this may seem insignificant, the income flows directly to the bottom line and remains an important component of net income.

The income stream derived from turnover rent models is only one beneficial aspect of reported sales.

The income stream derived from turnover rent models is only one beneficial aspect of reported sales. The ability to measure the performance of the centre and to benchmark individual retailers is at least as valuable. Leasing and renewal strategies can be determined by sales productivity. With sales information on national and international retailers from other centres, owners are in a strong position to determine the rent a particular retailer can pay, providing a strong negotiating position.

In the U.K., market practice continues to be largely characterised by fixed rents without an accompanying variable component related to performance.[21] These models also dominate leasing practices for high street units and retail parks across Europe. In the U.K. fixed rents are normally subject to periodic review to open market rent, usually every five years. However, since the late 1990s, the use of turnover rent models has become an increasingly common alternative to the practice of fixed rents for U.K. shopping centres.

6.3 Omni-Channel Challenges for Rent Models

The speed of transformation for both retailer and shopping centre owner business models has outpaced the response of rental models both in the U.S. and in Europe. Discussions with retailers and owners suggest that conventional lease models remain largely unaltered to date for four reasons:

1. **In an era of fast-paced digital innovation, the transformation of consumer shopping patterns remains dynamic, making it difficult to establish viable new rent metrics.** Both owners and retailers have been more focused on evolving their business models than on how rental models should reflect these changes. Where there has been some modification in lease structures, this has been largely driven by the usual market forces of demand and supply, rather than in response to the shift towards digitised business models and performance metrics. For example, in Europe a number of sub-anchors/M.S.U. (Medium Size Unit) retailers have sought to capitalise on the strength of their brand where possible. Beyond the top tier of destination centres where demand for space exceeds supply, certain such retailers have sought turnover-only leases on very favourable terms.

Although driven by economic fundamentals, these lease arrangements have highlighted the limitations of rental capture within current turnover rent models, with or without an accompanying base rent. This is because the same retailers are also pursuing omni-channel strategies that seek to maximise total sales. As part of that strategy, retailers are not only encouraging consumers to use the physical store as a delivery channel for sales transacted beyond the store, but are also equipping sales staff and consumers with devices that facilitate online orders from within the store. To the retailer, what matters is the occurrence of the sale, not where it eventually transacts. Information systems are evolving accordingly. Looking forward, QR codes combined with payments by smartphone will reduce the role of in-store payment terminals, with the transaction occurring directly between the customer and the retailer's accounts. This will render it even more difficult for owners to discern even in-store purchases.

For the shopping centre owner, the definition of turnover is brought sharply into focus, along with the contribution of the store to the consumer journey, whether the transaction occurs there or not.

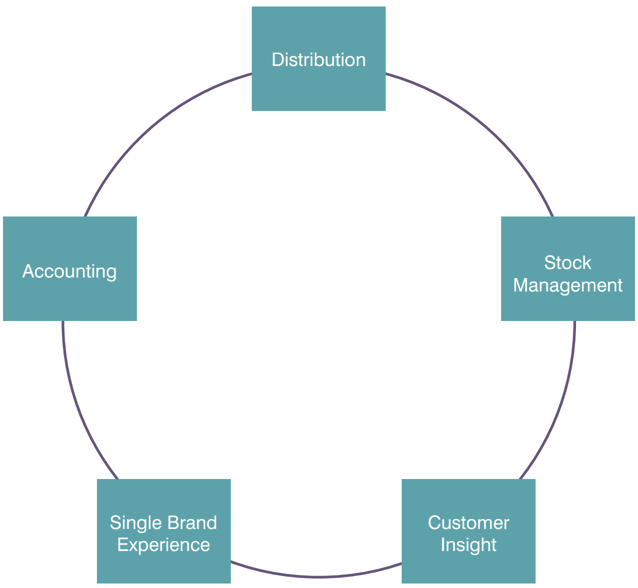
While traditional leasing models remain unchanged, this is also an early period for innovation and experimentation. Many owners and retailers are using their digital infrastructure to develop new performance measures and metrics, although they are not yet linked to rent models. These efforts will be discussed in greater detail in Section 7 of this report.

2. **Retailers in the U.S. and Europe are still experimenting with multiple elements of their omni-channel business model.** By some estimates, only 35% of retailers have a plan to implement their omni-channel model, suggesting that the industry still has a lot of work to do to successfully integrate the five key dimensions (as seen in Figure 13) to these operations:

- distribution;
- customer insight;
- inventory tracking and management;
- single-brand experience across multiple platforms; and
- accounting.

Retail business strategists suggest that not one retailer has successfully accomplished all five dimensions and that even the most advanced are still working on at least one core aspect of omni-channel.

FIGURE 13. 5 Key Dimensions to Omni-Channel Strategy



3. **Retailers are not yet able to isolate the contribution of the store to sales across multiple touchpoints.** A recent global survey of cross-channel retailers indicates that 57% of retailers currently run separate profit centres for in-store and online, although this is rapidly changing.[22] Some 23% have already merged or are merging online and in-store business and accounting lines. Geo-coding or geo-fencing is preferred by 18%, with all sales attributed to pre-defined geographic locations, usually anchored to physical store portfolios. Where the sphere of influence 'halo effect' of stores overlaps, the sale will be apportioned between locations using gravity models. A further 5% allocate according to customer loyalty. To this end, the methodology is very similar to that conventionally used to define shopping centre catchment and spending profiles. While total sales within a geo-fenced area may be anchored to a store, they will include pure online, click and collect, non-store mobile, in-store mobile in addition to sales captured in-store at the POS. Retailers recognise they need to better understand the store's contribution to the bottom line, but this is clearly a work in progress.

4. **Some owners feel that it is premature to consider developing new lease structures to take account of omni-channel business models.** With retailers still immersed in the integration of their platforms and with poor POS data, it is difficult to develop new models. Nevertheless, some interim steps are being taken. In the U.S., there has been an increasing emphasis on higher base rents, given the difficulty in

measuring sales. Some leasing managers have attempted to include lease clauses that count various online sales that can be attributed to the store in their reported sales. This has been met with limited success thus far, particularly since most retailers' POS systems do not measure these related sales. Nevertheless, there appears to be a broad understanding among owners and retailers that the store is central to the consumer journey, whether or not the transaction occurs in-store.

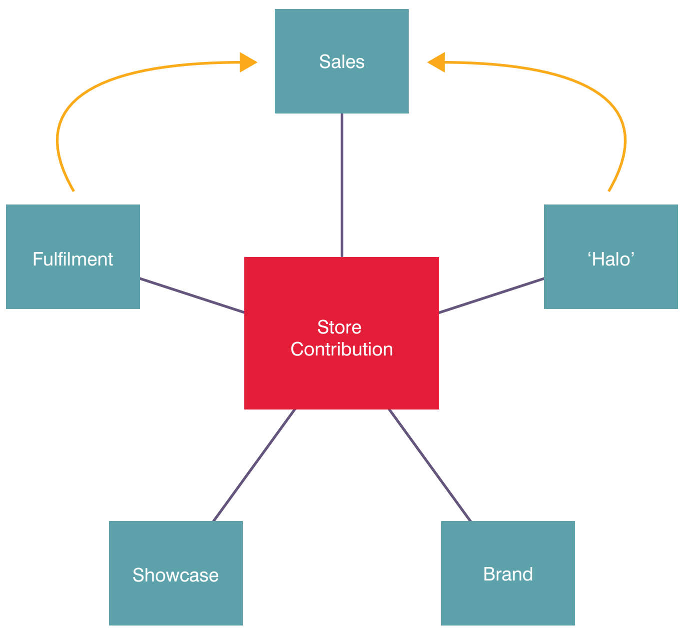
6.4 Capturing Store Value in an Omni-Channel World

The fundamentals underlying the rental value of a store have not changed. Rental values reflect the operational value of the store, the value of the customer opportunity and enhancement of the store's brand with those consumers. Historically, this value has been captured by the sales generated through that physical space, with rent-to-sales ratios usually employed to express the store's contribution to the retailer's bottom line.

The growth of the retailer's digital platform is fundamentally changing the store's value. It is empowering consumers, resulting in a much more complex customer journey. The store is now one of a number of sales platforms through which the retailer can engage, entice and transact with consumers.

What makes distinguishing the value of the store platform so difficult is that consumers are interacting with multiple touchpoints across these platforms for any one transaction. Achieving the sale in the most appropriate way is what matters and requires a dynamic approach (See Figure 14).

FIGURE 14. Stores Are the Cornerstone of Omni-Channel Retail



The role of the store varies depending on the consumer, by mood and according to the purpose of the shopping journey. This is recognised in retailers' store portfolios, with individual stores tailored to best meet their dominant functions within a particular location. For example, stores in the largest and most dominant destination and experience centres are used to showcase the brand's values and products, and to meaningfully engage customers in the brand experience through retail theatre and relevant customer services. This showcasing generates brand value for future or repeat business, in addition to immediate sales.

Stores within neighbourhood, community or edge-of-town retail centres/parks are often concerned with convenience and attentive, yet efficient customer service. Nevertheless, even with these more convenience-orientated centres, owners are establishing a sense of place and customer experience.

6.4.1 Click and Collect

Integrating touchpoints seamlessly across the customer journey is pivotal to omni-channel success. Click and collect has become an important role for a store. Discussions with owners and retailers suggest that click-and-collect sales are amongst the most complex and contentious in terms of value attribution to the store. Usually defined as a sale that is transacted online and guaranteed to be in store for customer collection, click-and-collect sales are not usually allocated to store turnover within the terms of existing lease agreements, although items that are reserved online and transacted in-store normally are accounted for within the store POS.

Some owners recognise that retailers with a strong omni-channel business that use click and collect as a significant fulfilment option can be a driver of footfall and incremental sales to the centre. Discussion with retailers indicated that a high proportion of consumers picking up a pre-ordered item from a store purchased an additional item in-store, with the percentage ranging from 20% to 50% of such customers depending on the retail business. A number of retailers further commented that individuals who do make an additional purchase in-store typically spend over 50% more than the cost of the original item.

Conversion rates are high for two reasons. First, the consumer entering the store is already a customer. Second, the retailer uses merchandising within the store to intercept and engage the customer in additional products. Retailers with a strong click-and-collect channel believe that the footfall and incremental sales generated for the shopping centre represent a net benefit captured at the store's POS.

A number of owners, especially of destination centres, contend that the contribution of the store to the retailer's ability to fulfil online customer orders should be recognised and that the sale should be attributed to the store when the store is contributing to that sale. Retailers generally resist this approach and suggest that they would simply shift the point of delivery. Some retailers also argue that since they have not yet integrated their inventory systems, they are not yet seeing cost advantages to click and collect. However, there is likely to be a middle ground for a couple of reasons.

First, **there is currently little cost advantage to retailers from click-and-collect fulfilment relative to home delivery**. This is due to the fact that very few retailers have an integrated online and outlet stock management system and even fewer are able to fulfil online orders through stock picking within the local store. Thus, there are no cost savings for fulfilment from click-and-collect options to date. However, this is an area of focus for retailers as they concentrate on turning growth in digital sales into profit and in deriving additional sales from consumers collecting from the store. Thus, store fulfilment will soon generate a tangible cost saving.

Second, **the alternative collection point to the store itself is unlikely to be cost free.** For example, in an effort to ensure delivery in the right place, a large-format European retailer sought to create a collection point at major transport hubs in France. The lease agreement for delivery was based on a percentage of turnover. The turnover rate was much lower than that usually agreed for store sales in shopping centres.

This example suggests that owners and retailers can find common ground as to the accounting and/or value of click-and-collect sales. Improved inventory management systems will accelerate this, enabling retailers to derive savings from using the store for fulfilment. However, it is unlikely that click-and-collect sales will be counted at the same rate as in-store sales.

6.4.2 Returns

Another fundamental role of a store in the omni-channel world is in accepting returns from online sales. Both owners and retailers appear to be in agreement that sales transacted online but returned to store should not be reported as a subtraction in store turnover data. Research suggests that returns typically generate additional sales in store that often exceed the value of the return, thereby contributing to the store's performance.[23]

6.4.3 Online Transactions In-Store

Perhaps the most contentious issue is reporting of online transactions occurring in the store. In an effort to better engage and improve customer service levels, many retailers are equipping sales staff with tablets within the store. This frees sales assistants from a fixed POS and enables them to assist shoppers knowledgeably and efficiently at the point of need.

As well as enabling customers to complete sales transactions anywhere in the store, the approach also increases sales rates by allowing customers to order and purchase items that are not in the store's inventory in terms of size or colour, or are from an extended merchandise range that is not usually available in-store. Similarly, retailers that might have a very wide product range in their large format and online stores are increasingly using fixed kiosks in-store to enable the customer to search a wider inventory than might be available in their nearest store.

There was some divergence in views regarding what should be attributed to the store. Many owners and some retailers contended that if a sale occurs within the store, even if on a mobile device, it is clear that the sale should be attributed as a store sale. A number of retailers explained that there are considerable development and operational costs, both digitally and logistically, underpinning sales of an extended product range through an in-store kiosk or tablet. Some of these retailers suggested that some proportion of the sale might be directly attributable to the store. Still others indicated that such sales should not be attributed to the store as the merchandise is not ordinarily available in-store and the contribution of the store is already embedded in the base rent.

6.4.4 The 'Halo' Effect

Due to the above, a number of owners proposed attributing a proportion of all sales that occur in the catchment area, whether online only, click and collect, mobile, or store sales, to the physical store. This would reflect the 'halo' effect',[24] or how a particular location can heighten brand awareness even for consumers shopping solely online.

Many online purchases mask a more complex customer journey that might include a pre-purchase store visit that enabled the retailer to engage the consumer and showcase the merchandise, precipitating a subsequent sale online. Retailers generally considered the contribution of the store to non-store sales to be a low proportion of the wider marketing strategy. Its value is considered to be embedded already in the base rent.

As previously discussed, research has indicated a strong relationship between a retail store and online sales generated within that trade area. In most situations, if a store is present, online sales are higher, given the branding, 'halo' effect and convenience for returns of a convenient physical store.

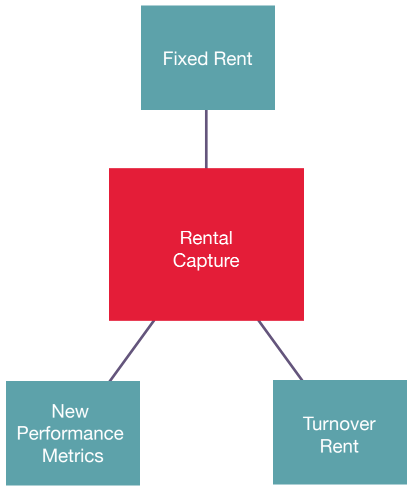
Owners and retailers have been attempting to better understand a store's value through its overall sales in that trade area. This reflects a recognition that the contribution of the store to retailer profitability is considerably more complex in the digital era and will vary with the role of a specific outlet within the retailer's portfolio and the mode of the consumer's shopping activity, for example, whether the individual is shopping for need or want, for convenience or experience, etc.

Given this greater complexity, structured discussions with retailers and owners considered whether conventional methods of rental assessment and performance measurement are still effective at capturing the value of the store. The research interviews further evaluated alternative approaches to capturing value and explored a range of new metrics that might emerge in the future as a measure of shopping centre performance and in turn, rental value. This resulted in a wide spectrum of approaches to capturing value that are of varying relevance to different types of shopping centres. This evaluation of a range of possible approaches provides a useful *toolbox* for selecting and devising current and future rental models.

7.0 THE TOOLBOX

The approaches to capturing store value put forward by owners and retailers within the research interviews are wide-ranging and may be broadly grouped into three principal categories. These include fixed rents, turnover rent models and potential new rent models based upon alternative performance metrics (Figure 15).

FIGURE 15. The Toolbox

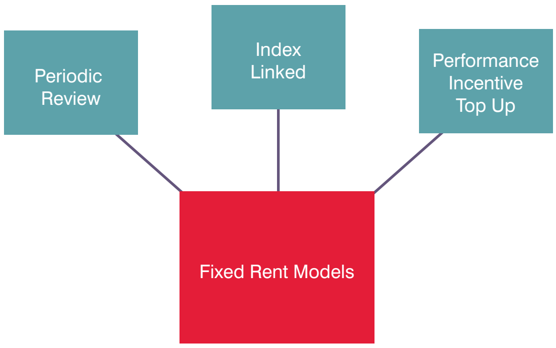


7.1 Fixed Rent Models

Fixed rents dominate leasing models in shopping centres in the U.K. and on high-street retail elsewhere in Europe and upscale streetfront retail in the U.S. (Figure 16). Some owners argue that the advantage of this model is that a negotiated rent based on competitive market forces is the best indicator of a store's value to the retailer who can best benefit from that space. From the retailer's perspective, the fixed rent accounts for the overall contribution of the store to total sales, no matter the retail channel.

This model bypasses the need to account for in-store vs online sales that can be attributed to the store for the purpose of determining rent. Retailers are attracted to the certainty of the rental cost that fixed rent models provide. However, they argue that the periodic review of rental levels in the U.K., usually at five-year intervals, erodes this benefit and that the lack of transparency beyond year five represents a major risk.

FIGURE 16. Fixed Rent Models



The U.K. rent review process is based upon comparable rent evidence, which in a shopping centre environment is largely under the control of the owner. Being quasi-judicial in nature, this results in a particularly adversarial process.

Many retailers interviewed commented that the level of uncertainty as to whether rental levels would remain affordable post-review is driving some retailers towards shortening lease lengths or ensuring there is a break clause at review. Retailers favour fixed rental levels being increased in line with an agreed index-linked benchmark, commonly related to inflation, as is typical in U.S. and continental European markets. It has emerged as an alternative to rent reviews in the U.K. and represents a growing segment of the market since 2000.

Although recognising that an open market-negotiated rent clearly indicates the market worth of a store at the time of the lease, many owners continue to prefer the inclusion of a performance-related income stream. In addition to a base rent, this performance-related income rewards owners for continuing to innovate, collaborate and develop best practices.

Moreover, a number of participants suggested that fixed rental models lead to a low alignment of interest between owners and retailers at a time when effectively responding to consumer change requires increasing collaboration between the parties. Both owners and retailers contend that performance metrics help ensure that what gets measured tends to get done. However, there is less agreement as to what should be measured.

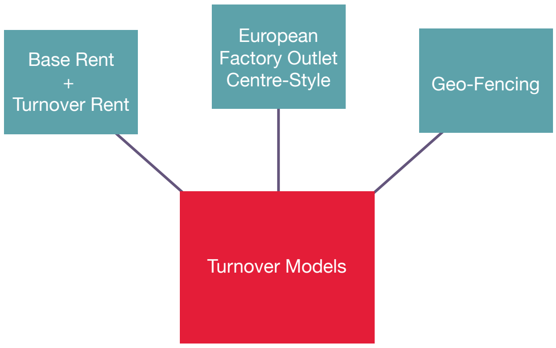
7.2 Turnover or Percentage Rent Models

Many owners and most retailers favour turnover or percentage rent models. However, opinions varied widely amongst and between the groups as to how this might best be achieved.

There are positives and negatives in adapting this sales volume-based metric to the omni-channel retail market. Many retailers consider that a performance-related income stream should lead to better management by owners. An income component that is based upon retailers' sales performance incentivises owners to continue to focus strategy on sales generation and increased market share, and motivates them to closely monitor the impact of their strategies through reporting of sales. However, in an omni-channel world, store sales cannot capture the contribution of the store to total sales.

The sales turnover-based models may be categorised into three broad groups: conventional turnover models, European factory outlet centre-style models and geo-fencing models that draw from airport retail models (see Figure 17).

FIGURE 17. Turnover Rent Base Models



7.2.1 Conventional Turnover Rent Models

Conventional turnover rent models include a base rent accompanied by a variable income calculated as a percentage of sales achieved above a certain threshold. Commonly utilised in the U.S. and continental Europe, base rent comprises from 90% to 98%[25] of total rent across portfolios in the U.S. and from 95% to 100% in Europe. Analysis of data relating to leasing practices in the U.S. shows a **long-term shift toward higher base rents in high-quality centres, thereby diminishing the impact of percentage rents**. Some owners have indicated that this higher base rent somewhat compensates for sales that they believe are associated with the store but are not reported as such.

Nevertheless, these turnover rents are an important part of income, as they flow straight to the bottom line. In addition, reported sales allow an owner to better track the retailer and centre's performance. It becomes a key tool in lease negotiations.

Indeed, recent analysis of the sales and rental performance of centres reveals a negative relationship between sales productivity and net asking rents, suggesting that the variable performance component of rent captures growth.[26] Although the analysis is not broken down by type of centre and, therefore, likely masks the differential performance of segments, it concludes that omni-channel strategies complicate the traditional leasing process and this is likely to impact future lease structures.

Most retailers are keen to retain a link to sales in the performance-related rental metric. Many of those interviewed stated that while the role of the store is multi-functional, individual stores are still required to deliver an appropriate rent-to-sales ratio to achieve a target profitability return.

Some owners preferred a turnover rent model. However, they commented that while turnover levels in their shopping centres have remained broadly stable in real terms in recent years, they believe that growth is drifting online, with the store used as part of the delivery solution by way of click and collect and other means. To capture this value, these owners suggested the inclusion of click and collect and in-store online sales in their reported turnover, as hinted earlier.

Turnover rent models can become attractive options in second-tier centres, where demand for space may be much lower than for destination centres. In these instances, a lower-than-usual base rent might persuade a desired tenant who may not be certain of its performance to locate in the centre, helping to share risks and more closely align interests, while compensating the owner for strong sales performance.

A number of retailers in both the U.S. and Europe said their profit margins are typically higher in these centres than in highly competitive first-tier centres. Indeed, retailers seeking prime spaces in luxury retail high-street or upscale streetfront locations include a marketing value within the budget for a store to justify very high rents. Most shopping centre-based retailers are only starting to value this relationship explicitly, but it is already implicit in the acceptance of higher rent-to-sales ratios for premium centres.

7.2.2 European Factory Outlet-Style Leasing Models

European owners of some neighbourhood and also of more challenged mid-sized centres suggested rent models more commonly associated with European factory outlet centres. These involve a turnover rent model, usually including a lower base rent than for conventional turnover rent models.

An important component of such models is the absence of security of tenure—that is, the retailer's right to renew the lease. Security of tenure is common to varying degrees to landlord and tenant law in most European countries. However, given the importance of retailer performance to income, factory outlet centre lease agreements include the owner's right to terminate a lease if a store consistently fails to reach an agreed sales target.

As discussed previously, some of the most successful retail brands that act as sub-anchors in European centres have negotiated turnover-only leases in neighbourhood and second-tier centres in recent years, while also retaining rights to security of tenure. Nevertheless, interviews with retailers indicate that many would forego security of tenure if the right to terminate the lease were linked to an agreed rolling performance benchmark and owners participated in greater risk sharing. A number of retailers further explained that once base rents are agreed upon, the owner is much less exposed than the retailer to lower-than-anticipated footfall and sales across the centre, given the very low performance component of rents. In short, while the performance element ensures that income can increase if the centre performs in line with or better than expectations, it cannot decrease if it underperforms, excepting, of course, tenant default or rental revisions.

Most retailers recognised the need for a significant base rent to lower risk, secure a stable income base and achieve financing. However, they suggested that the variable, performance-related component of rent should be a larger proportion of total rent, with a range from 75% to 85% cited. These retailers contended that this would provide for greater risk sharing that would reduce the requirement for security of tenure. Some retailers stressed that, while terminating the lease of a non-performing retailer might be in all parties' interests, the right to end a lease must be performance-linked rather than arbitrary.

According to this line of thinking, the turnover rent model negotiated, which will likely include caps, floors and stepped hurdle rates, should, rather like the implicit value of a fixed rent, reflect the total value of the store within a retailer's omni-channel business model. This would imply that the proportion of sales transacted online will grow in tandem with the percentage rate applied to store sales. This implicitly reflects the store's contribution to the customer journey underlying online transactions. In other words, the turnover rent slice of the store sales pie would increase if total sales increase faster than store sales, but the store's role remains pivotal to total sales growth.

Those owners and retailers favouring fixed rent, conventional sales turnover and European factory outlet-style leasing models see store value being captured through an open market-negotiated rent. To this end, the value of the store's contribution to the wider omni-channel strategy (and equally the value of the retailer to the wider asset strategy) will be embedded implicitly in the rent. This is certainly true of negotiations for a new lease, although given that the omni-channel retail model has not yet reached maturity, it is less clear when relying on comparable evidence to estimate rental values upon lease renewal, or for fixed rents at rent review.

7.2.3 Geo-Fence Turnover Models

Most omni-channel retailers in the U.S. and Europe are striving to merge their online and in-store accounting systems in order to better understand overall sales. Many are creating location-based profit centres, using their store portfolios to anchor and define appropriate geographic areas. Using postal or other locational codes, online sales are geo-coded and attributed to store-based locations. This knowledge enables retailers to quantify the value of a consumer opportunity within a specific location. It also enables them to understand in more detail the contribution of different consumer touchpoints, including the store, to the customer journey.

From the owner's perspective, understanding how the retailer is performing in the catchment area through total sales is also very valuable. A participant in the research interviews explained that if a store's sales decline, a retailer's decision whether or not to stay in a centre may depend on trends in their total sales in the catchment area.

Understanding the size of the total pie is crucial to assessing the value of the store.

Understanding the size of the total pie is crucial to assessing the value of the store. Of course, additional costs associated with operating a digitised platform in terms of logistics, stock management marketing, etc. also need to be taken into account. The next step involves apportioning the contribution of the store to the different types of customer journey, which is an area of growing expertise for many retailers and owners.

A number of owners favoured a more explicit approach to capturing the value of a store within omni-channel business models, predominantly in conjunction with a base rent. Drawing from experience of airport retail models and other transport hubs, where percentage rates applied to sales vary according to the customer's buying behaviour and type of product, these owners would apply different rates of turnover to different sorts of transactions, reflecting the variable contribution of the store.

For example, a sale in the store is likely to have the highest percentage turnover rate applied, while a non-store online transaction would apply the lowest turnover rate, reflecting only the regional halo effect of the store. Click-and-collect transactions would register a rate somewhere in between reflecting the greater contribution of the store to customer fulfilment, but also the additional costs of achieving the sale to the retailer and the value of click and collect to the centre. It should be noted that in the U.K. retailers provide payments of around 6% of sale price for items marketed online through click-through coupons placed on third-party websites or web-mails.

A performance model that recognises the variable contribution of the shopping centre to the wide range of customer journeys is favoured by many owners, although most thought that retailers' reluctance to share data would be a barrier. Although many retailers recognise the validity of the approach, particularly if accompanied by greater collaboration between owners and retailers including more risk sharing, the success of such a model will depend upon its details.

Individual lease agreements will continue to reflect the balance of power between the retailer and owner. More embryonic retailers—those with weaker covenants or online-only retailers seeking a physical presence—may be open to collaborate more with owners.

Where such retailers can help differentiate a centre, owners may be willing to take a limited risk. However, as anticipated by owners, many retailers are reluctant to share sensitive data. In the U.S., similar shared revenue approaches have been used in partnerships between manufacturers and/or pure-play and bricks-and-mortar retailers. A jewellery supplier and online retailer, for instance, created partnerships with independent retail stores that it supplied. The independent retailer receives a portion of every transaction in an agreed geo-fenced area and shares different margins on goods bought through the store to those purchased on a click-and-collect basis.[27] Similarly, the relationship and profit sharing between brand owners and franchisees is shifting, notably in department stores. Previously, brands relied on franchisees to initiate and develop customer relationships, with franchisees often having full autonomy on merchandising and management. While the franchisee's role as the personal face of the brand remains, the brands themselves are now able to engage directly with consumers through other sales channels, especially through on-line advertising, social media, email messages and their websites. As a result, the franchisee still remains an intermediary between brand and customer, but in a more diminished position. However, the franchisee's role in fulfilment and showcasing product has increased.

7.3 Use of Alternative Performance Metrics with Leasing Models

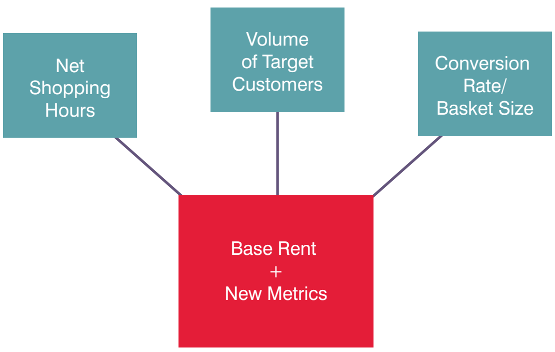
A number of owners of both destination and neighbourhood centres in the U.S. and Europe hoped that alternative metrics might reward them for their operational management expertise. Such owners' business models have transformed shopping centres into places that attract, entice and engage by delivering on experience, convenience and exceptional customer service. These owners are delivering the customer opportunity, not merely space, by driving high-value traffic to their stores. On the other hand, retailers would be willing to accept metrics that reward them for stronger volume and value of consumer opportunity if owners invest in innovative asset strategies that generate these results.

Retailers confirmed that they are buying into the customer opportunity provided by progressive owners who produce an operational, customer-facing business, not merely an income-producing real estate asset. While most retailers agreed that owners should be incentivised for delivering more, any new performance metrics remain undefined. Yet, to the extent that new metrics are developed, they should supplement sales data, which remain central to gauging a store's performance.

Both owners and retailers acknowledge that once customers are inside the store, conversion rates are principally driven by a retailer's products, price and customer service level. Moreover, a proportion of the sales generated will occur online. Indeed, a number of retailers explained that finding appropriate metrics to reward owners and managers for delivering a stronger customer opportunity mirrored the difficulty in rewarding sales staff. The more permutations involved in completing a purchase, the harder it is to measure how much good customer service or sales technique contributes to in-store turnover.

Whilst owners and retailers acknowledged the difficulty in finding these metrics, they were not lacking in recommendations that might be used for hurdle rates linked to rental income. Many of these relate to existing key indicators already used to monitor the performance of the centre and individual occupiers, as well as new metrics to incentivise retail staff more effectively in an omni-channel era. Among the new performance metrics to emerge from the discussions were: net shopping hours; volume of agreed-target customers; and conversion rates and basket size (Figure 18).

FIGURE 18. Alternative Performance Metrics



7.3.1 Net Shopping Hours

Footfall and customer flow are monitored by all the major destination shopping centre owners interviewed. However, tools for measuring these range widely in sophistication and accuracy. Such measurement, not often found in neighbourhood and community centres in the U.S., is more common in Europe.

With an increasing emphasis on place-making, some owners consider net shopping hours an effective performance metric measure. This measures both the volume of consumers and their dwell time, thereby providing a measure of the consumer opportunity afforded. Indeed, it was commented that where data illustrated that a retailer's individual marketing activities and/or presence generated a valuable net benefit for the centre that was not already reflected in the lease agreement, that such retailer could be rewarded with rental discounts and/or lower service charge, or a rental holiday within turnover catch-up metrics.

Some owners of neighbourhood and larger convenience schemes in Europe favoured this approach. These owners are focused on developing asset strategies and marketing initiatives that increase the number of visits to the shopping centre by customers and extend the dwell time of such consumers. These initiatives involve the co-location of public services and leisure operators, for example health centres and gymnasiums, which are low-income generators. Where such strategies significantly increase the customer opportunity, owners and managers also wish to be rewarded directly for the opportunity cost of alternative income.

7.3.2 Volume of Customers

A number of owners suggest using new technology such as beacons to develop more refined metrics that quantify the volume of agreed-target customers, rather than simply footfall. While this technology is still in its infancy, it is evolving rapidly. Although capabilities between beacon technologies vary, most are now able to track individual consumers by the IP address associated with a smartphone. Such tracking is possible regardless of whether a consumer opts-in or the phone is switched on, so long as phone location services are enabled. More granular information is achievable where users download or sign-in to shopping centre apps or other digital media operated by the centre.

Essentially, owners and retailers agree upon the characteristics of a store's target consumer—their customer—and agree on appropriate hurdle rates. While of interest in principle to a number of owners of destination, convenience and more challenged schemes, the application of new technology, together with the management and analysis of the data amassed from it, is not yet advanced enough to enable this, they acknowledge. However, it was considered that a metric based upon such agreed-target customer volumes might be incorporated into lease agreements, especially with respect to performance, in the future.

7.3.3 Conversion Rates and Basket Size

A number of retailers stressed that the vast majority of sales still occurred in-store. While the store is one of many touchpoints along the consumer journey, it is a particularly important one. Most transactions, whether in-store or online, involve the store at some stage of the journey. The store provides a face-to-face interaction between the brand and the consumer and a multi-sensory marketing opportunity. In this context, those retailers argued that new metrics, while valid and desired, need to retain a link to sales turnover. In contrast, some owners and retailers argued that owners and managers are required to deliver the customer, but conversion to sales within a store is the responsibility of the retailer. Once inside the store there are many variables impacting on conversion rates that only the retailer can influence: principally, product, price and service. From this perspective, some owners and retailers argued that the owner's performance should be based on delivering a pre-agreed volume of a defined customer profile to the retailer's unit and not on the retailer's ability to convert this flow into sales.

In addition, many retailers commented that the issues generated by omni-channel retail for rent models are generating parallel issues for sales staff with a performance-related component to their pay. In the same way that a value of a store should reflect its contribution to total sales in a given location, remuneration policies must ensure that staff members are rewarded for their contribution to a sale regardless of where the transaction takes place. Depending on how integrated its platforms are and how advanced its customer insight tools are, an individual retailer might be able to achieve this through effective tracking of customers across their sales channels. Others use customer survey-based data as a proxy to understand the contribution of the store to online transactions. It was suggested that such approaches could also be useful as rental performance metrics.

Retailers have traditionally employed key metrics such as conversion rates and basket size to benchmark store performance. As retailers develop their ability to track consumers across multiple platforms and gain insight into the cross channel buying behaviour of individual customers they are able to refine these key store metrics to include online sales that were influenced in-store. One suggestion made was that both traditional and evolving store metrics could also be employed for a performance-related rental component.

Conversion rate and basket size benchmarks link footfall, or potentially customer volume, to sales by measuring both the number of consumers that transact and the average basket size of transactions. Basket size could be easily achieved for the centre as an entity where footfall data are collected and sales volumes are reported to the owner/manager. Increasingly, conversion metrics will also be achievable, enabled by digital and video tracking. Employing such metrics at the centre level allows for performance metrics to consider the value, not merely the volume of consumers. Linking this benchmark to a performance-based top-up rent with agreed hurdle rates might better align owner and retailer interests.

These measures could also be employed to benchmark the performance of individual retailers against their relevant sector or sub-sector within the centre. This would require retailers to report key metrics, or owners/managers to count/digitally track consumer flow passing and entering a unit. While retailers are often required to report sales data for management purposes, current leases often stipulate that such data may not be used to influence rents. As such, while owners are able to readily calculate such metrics and retailers would be interested to understand their relative performance against an appropriate benchmark, their use as new rental metrics requires retailers to reconsider how such data might be employed. Moreover, such benchmarks would be more powerful if retailers were also able and prepared to provide total store-influenced sales.

8.0 OUTLOOK

This research explores how the digital era has accelerated the pace of retail change—a process with little prospect of slowing any time soon. Over the past 15 years as online retailing has captured a larger portion of sales, owner and retailer interests have become more closely aligned, yet the structure of rental agreements remains broadly the same. In recent years, the changing role of stakeholders means that owners and retailers understand that they must work even more collaboratively. In the near term, the historically adversarial relationship between landlord and rent-paying tenant is unlikely to disappear. It is clear that the evolution of rental agreements to accommodate the new reality is at an early stage of development.

Appropriate solutions will vary between different types of centres in terms of function and scale, and between different types of retailers in terms of sector and brand power for the tenant mix.

On the positive side, these interviews have identified much common ground between many owners and retailers as to the preferred way forward. Clearly, differences exist about details, but it is heartening to know that retailers and owners share goals and will increasingly do so in the future.

If current leasing models are 'working, but creaking', the industry will start to refurbish or replace them. Appropriate solutions will vary between different types of centres in terms of function and scale, and between different types of retailers in terms of sector and brand power for the tenant mix. Indeed, any lease will remain a negotiated contract between individual parties.

It is likely that initially, innovative lease models will emerge from more challenged centres; after all, necessity is the mother of invention. The toolbox emerging from this research aims to provide a wide range and spectrum of alternatives, organised in a logical framework that is intended to assist, rather than prescribe, the development of future lease models.

In this fast-paced era of continuing innovation, business models will continue to evolve as retailers and owners anticipate and adapt to change. However, given that omni-channel retail involves the blurring of two of the most dynamic and innovative industries—retail and technology—it is equally certain that solutions will emerge. For this reason, this study may have to be revisited shortly.

LIST OF CONTRIBUTORS

We offer our warm thanks and appreciation to those who contributed in structured interviews to this study. Most individuals wished to remain anonymous and have their company's participation acknowledged. The report would not have been possible without their assistance.

Interviews drew upon individuals' knowledge and experience of the shopping centre industry and do not necessarily represent the view of their employers. For this reason, there were a number of instances where more than one individual was interviewed from the same company.

Of course, those contributing information are not responsible for the views expressed in this report.

Aberdeen Asset Management
Airsage
Altarea Cogedim
Appear Here
Barclays
Bestseller
British Retail Consortium
Bucksbaum Retail Properties
CBRE
CBRE Global Investors
Citibank
Citycon Oyj
Colliers International
Corio N.V.
(merged with Klépierre 31.03.15)
Cornish & Carey
CoStar Group
Cushman & Wakefield
Debenhams PLC
Deutsche Asset Management
ECE Projektmanagement
G.m.b.H. & Co. KG
Foot Locker Inc, Europe
Fung Group
Futures Coaching
Gap (Europe) Inc
General Growth Properties
Green Street Advisors
Hammerson
IC Group
Intu
J Crew
Javelin Group (acquired by
Accenture Strategy, 29.06.15)
Jones Lang LaSalle
Klépierre
Land Securities
LaSalle Investment Management
Lincoln Property Company
Lululemon Athletica
Macerich
Mackays Stores Ltd
Macy's
Madison Marquette
Mango
Media Saturn
Milligan Retail
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Mothercare PLC
Multi Corporation
Next Plc
Nomi
PathIntelligence
Property Market Analysis LLP
Ramco Gershenson Property Trust
Reteam Group
Simon Property Group
Sonae Sierra
Taubman
Telsey Group
The Disney Store
The Lego Group
Travis Perkins Plc
TriGranit Corporation
Wells Fargo Securities
Westfield Corp
Westfield LLC
Williams-Sonoma
Woodbury Corporation
Yum!

NOTES

[1] According to a 2013 survey by *Multichannel Merchant* and Neustar, 35% of retailers indicated they had already implemented an omni-channel strategy, while another 27% planned to do so; however, 38% reported no plans of any kind for this. 'Optimize Omnichannel Engagement With Actionable Consumer Insights,' p. 4, https://www.neustar.biz.

[2] All interviews were conducted with the understanding of strict confidentiality, so that individual sources of comments will not be cited here. However, companies that have contributed information and insights to the project are acknowledged.

[3] Bill Gates, *The Road Ahead*, Penguin, 1995.

[4] JLL, 'Retail 2010'; *Retail Futures Programme*, 1999; JLL, 'Ten Forces for Retail Change,' *Retail Futures Programme*, 2001.

[5] JLL, 'Converging Re-tail and E-tail Windows – Opportunity or Threat,' London, 2000.

[6] Centre for Retail Research, 'Online Retailing: Britain, Europe, US and Canada,' 2015, http://www.retailresearch.org/onlineretailing.php.

[7] Javelin, 'Organisational Structure: Transforming the Structure of Your Organisation for True Omni-Channel Retail,' 2014; McKinsey, 'Making Stores Matter in a Multi-Channel World: Perspective on Retail and Consumer Goods,' Summer 2014, http://www.mckinsey.com.

[8] More than four-fifths (87%) of retailers believe that an omni-channel strategy is somewhat to very important or critical. See *Multichannel Merchant* and Neustar, p. 5.

[9] Deloitte, 'The Changing Face of Retail,' 2011, http://www.deloitte.com.

[10] PWC/JDA, 'Global Retail and Consumer Goods CEO Survey: The Omni-Channel Fulfillment Imperative,' December 2014, http://www.jda.com.

[11] According to Nielsen, 13% of Americans as of 2014 subscribed to Amazon Press, which allows for free shipping. See Emily Steel, 'Nielsen Charts Reach of Video Streaming,' *The New York Times*, March 12, 2015, p. B4, http://www.nytimes.com/2015/03/12/business/nielsen-reports-2-in-5-us-households-subscribe-to-video-streaming-services.html?_r=0.

[12] Amazon has not booked a consistent profit nor issued dividends since it was founded, and yet has a market capitalization of $225 billion, as of July 17, 2015, according to Fidelity Investments.

[13] McKinsey, 'Digitizing the Consumer Decision Journey,' June 2014, http://www.mckinsey.com.

[14] Genesta, 'The Case for Real Estate Investing in Sweden,' January 2014; Genesta, *Investment Strategy Update*, January 2015, http://www.genesta.eu.

[15] CBRE, 'How Global is the Business of Retail?' *Global Research*, April 2015, http://www.cbre.com.

[16] A February 2014 study by Deloitte revealed that in a sample of women's apparel stores in the U.K., online sales provided a net boost to sales, only cannibalising in-store sales by less than 3%. Andrea Pozzi of the Einaudi Institute for Economics and Finance in Rome studied a major U.S. grocer and determined that even for this convenience-orientated retailer, for every $1 in sales captured online, only $0.35 was cannibalised from the store.

[17] Athleta, Baublebar, Birchbox, Bonobos, Boston Proper, Charles Tyrwhitt, Figleaf.com, Frank & Oak, Indochino, Nasty Girl, Rent the Runway, and Warby Parker are a few examples of online-only retailers that have opened physical stores.

[18] Camera and other counter systems are reported to miss customers who are walking close together, and may count shopping carts, pets or other objects.

[19] Identification of customers is in the aggregate, giving their area of residence and likely demographic traits; in contrast, individual identification would present legal and privacy issues.

[20] For example, Intu and intu.co.uk and Altarea and rueducommerce.fr.

[21] In the U.K., fixed rent is a 100% rent, with no performance element. It is also common to other formats, like retail parks/big-box and high street. On the other hand, base rent is the element of fixed rent (non-variable) in a lease with a performance element, usually turnover percentage.

[22] Ebeltoft Group, 'Global Cross Channel Retailing Report, 2014,' 2015, http://www.ebetoftgroup.com.

[23] ICSC, 'Shopping Centers: America's First and Foremost Marketplace,' 2014, http://www.icsc.org/.

[24] Bank of America Merrill Lynch, 'Consumer & Retail Conference' (Bloomberg Transcript), Macy's presentation, March 11, 2014, p. 6; Accenture, 'Trading Spaces: Changing the Way Retailers Think about Stores,' 2012; Javelin Group, 'How Many Stores Will We Really Need? U.K. Non-food Retailing in 2020'; Retail Think Tank, 'How is the Internet Changing Retail?', May 2010; KPMG/Synovate Retail Think Tank, 'White Paper #16,' KPMG/Ipsos 2010.

[25] In the U.S., based upon a review of annual reports for the five dominant mall shopping centre owners; in Europe, based on findings of structured interviews.

[26] CBRE Research, 'Mall Sales Performance Hints at Paradigm Shift for Lease Structures,' July 8, 2015, www.cbre.com

[27] Darren Dahl, 'An On-Line Vendor Creates Links with Brick-and-Mortar Stores,' *The New York Times*, January 7, 2015, http://www.nytimes.com.

ICSC

DSM Part 2:

What is omni-channel and why should the EU care?

INSIGHT PAPER

June 2016

The International Council of Shopping Centers (ICSC) is the global not-for-profit trade association for the retail real estate sector representing owners, developers, occupiers, investors, retailers and service providers. It has a diverse membership with over 70,000 members globally in 100 countries and over 7,000 members across 45 countries in Europe. Our industry and membership represents over 200 million m² of floorspace covering a variety of retail formats.

Executive summary

1. Omni-channel retail is removing the traditional boundaries between online and offline retail – with all the policy challenges this implies, in particular the need for a **level playing field** between the rules governing brick-and-mortar retail and those governing e-commerce.

2. Far from diminishing the **role of the physical store**, digital retail has expanded it. Most omni-channel strategies are anchored on store portfolios, with their value extended from being a point of sale to the **backbone of omni-channel retail operations** and marketing strategies.

3. As the true value of a retail space is now based on both in-store sales and the contribution of the store to online sales, **traditional turnover rent models** are not fit for purpose anymore and put the business model of the retail real estate sector at stake.

4. New technology, together with wider structural economic and societal macro trends, has facilitated and accelerated changes to **consumer buying behaviour**. The consumer decision-making journey is more complex, involving cross-channel shopping activity pre-, during and post purchase.

5. Where a sale is booked is no longer an indication of all the factors that contribute to a sale. Focusing on **sales allocation** is misleading, and masks the complexity of the customer's decision-making journey and the symbiotic relationship across the physical and online sales channels.

6. In order to transform into an omni-channel operator, retailers must integrate all aspects of their business models, which requires **considerable investments**. Even the most advanced retailers have yet to fully implement their omni-channel strategies.

7. Retail real estate owners are acting as an enabler for omni-channel retail, providing enhanced services for customers and assisting retailers with their distribution and fulfilment strategies, leading to a more **collaborative approach** between owners and retailers.

8. New technologies are being explored both by retailers and owners. As well as engaging with customers and providing them with enhances experience and service, this digital infrastructure enables a much deeper **understanding of consumer behaviour** across channels.

9. Any legislative gap between the rules governing in-store sales and those governing online sales threatens to distort fair competition in the single market and to slow down the **innovation impetus** in the retail sector.

Introduction – why this paper?

The aim of this paper is to raise decision-makers' awareness on the policy implications of the structural shifts the retail sector is undergoing with the emergence of omni-channel business models. There is a growing consensus that the brick-and-mortar vs. e-commerce debate is long outdated, but what is less well-known is why it is outdated – yet this is what matters most when legislating.

Retail real estate owners have been quick to innovate and recognise the opportunity that the digitalisation of the retail value chain presents for businesses and consumers alike. However, major restructuring of retail business models is ahead of us across multiple dimensions including logistics, inventory management, distribution, customer insight, merchandising, marketing and accounting – and even the most advanced market players have yet to fully embrace this new paradigm.

Legislation can hardly keep up with the scale and rapid pace of change that is driven by the digital revolution, raising challenging policy issues for public authorities. That is why the European Commission endorsed in May 2015 a strategy aimed at better adapting EU legislation to the digital economy.

Although there is much in the Digital Single Market (DSM) Strategy that is forward-thinking, the risk with legislating in a constantly evolving framework is not to get the whole picture and underestimate the complexity of the new reality – in particular here, the omni-channel reality. Notably, after having defined omni-channel retail, this paper focuses on five topics which are being covered in the DSM Strategy:

1. Contract rules for the online sale of goods
2. Unjustified geo-blocking
3. VAT for e-commerce
4. Big data
5. Online platforms

It is of the utmost importance that policy-makers are aware of the intricacies of the retail sector today, ahead of the roll-out of the DSM Strategy.

What is omni-channel?

It is critical to get this one right to understand the growing complexity of the European retail sector. More specifically, clear distinction has to be made between multi-channel and omni-channel retail to understand the policy implications that the latter raises.

Over the past decade, it has becoming clear that the consumer browsed online and shopped in-store and vice-versa. In most markets, the first decade of the 21st century witnessed a rapid shift from a binary market of pure-play e-tailer versus brick-and-mortar retailer to one dominated by multi-channel retailers. Even pure-play e-tailers have started to establish some form of physical retail presence to increase their market share.

Consumer behaviour is no longer binary either. More importantly, consumers have seamlessly integrated technology into their buying behaviour. Shopping journeys are complex and vary between consumers and across different modes of shopping. Consumers browse inventories, compare and research products online and/or in-store in advance of a purchase.

Fulfilment of the product is also variable and may be received immediately in-store, collected from store or delivered to home or an alternative address or collection point. The customer journey also extends beyond the purchase decision with the post-purchase experience, which includes reviews and returns, but also presents the opportunity for retailers to make further recommendations and target highly relevant offers to consumers based on their purchase history.

This approach requires multi-channel retailers to shift from essentially operating separate retail platforms towards one, integrated platform. **This is omni-channel retail**.

For omni-channel retailers, what matters is that the sale occurs and that customers' experiences are positive. Customers expect a 'one-customer, one-company' service, a demand that exceeds many retailers' capabilities. Omni-channel shopping behaviour forces retailers to mature from multi-channel platforms to an omni-channel organisation, which requires considerable investments throughout the whole value chain.

In order to transform into an omni-channel operator, retailers must integrate all aspects of their business models. Nearly all market players have incorporated this goal into their business plans, but few have achieved full integration at this point in time. Central to this is the integration of teams to enable a holistic approach to understanding customers, developing the retail proposition, selecting stock, tracking inventory, merchandising and marketing strategies.

Before going any further on the DSM Strategy, the following is a telling example of how omni-channel is changing retail at its core, by challenging the sustainability of traditional retail leasing and rental models.

Traditional leasing models are not fit for purpose anymore

In-store sales are no longer an accurate proxy for the contribution of a store to total sales. Consumers are engaging with multiple in-store and online touchpoints before actually buying. As such, the role of the store is changing. Retailers are pursuing omni-channel strategies that seek to maximise total sales. They are not only encouraging consumers to use the physical store as a delivery channel for sales transacted beyond the store, but are also equipping sales staff and consumers with devices that facilitate online orders from within the store. What matters to the retailer today is the occurrence of the sale, not where it eventually transacts.

Despite the above, rental models for capturing the value of a store have remained broadly unchanged. Conventional models are predominantly used. These include a base rent accompanied by a variable income calculated as a percentage of sales achieved by the retailer (tenant) above a certain threshold – often referred to as turnover rent.

Consequently, as consumer journeys become more complex, turnover rent models fail to reflect the true value of a store to one retailer's total sales, as they do not capture the contribution of the store to the sales that occurred online. To address this issue, real estate owners (landlords) are increasingly proposing geo-fence turnover models, whereby one store's turnover includes all sales within an agreed catchment area. Using postal or other locational codes, online sales are geo-coded and attributed to specific store-based locations.

Nevertheless, retailers tend to be reluctant to share turnover data on non-store sales with owners, and lease agreements continue to reflect the balance of power between the retailer and the owner. More embryonic retailers may be open to collaborate with owners, but large retailers may use their bargaining power to maintain traditional turnover rent models – although these are not fit for the omni-channel reality and put the business model of shopping centres, as well as of the retail real estate sector as a whole, at stake.

Omni-channel shakes the very foundation of the retail sector. Whereas multi-channel has blurred the traditional boundaries between online and offline retail, omni-channel is removing them – with all the policy challenges this implies, in particular the need for a level playing field between the rules governing brick-and-mortar retail and those governing e-commerce. It is therefore essential that EU policymakers examine how omni-channel is transforming the retail sector in the same way they are considering the upheavals caused by e-commerce.

Recommendations

- ICSC supports the European Commission's aim to examine the impact of the relative bargaining power of some actors when negotiating terms and conditions with other market players for online platforms; similarly, ICSC recommends the European Commission to examine the impact of the relative bargaining power of some actors when negotiating terms and conditions (e.g. lease agreements) with other market players for offline platforms, i.e. for retail real estate.

1. Sales contracts: from one legal fragmentation to the next

In late 2015, the European Commission published the first legislative proposals to be presented as part of the DSM Strategy – one on the supply of digital content and one on the online sale of goods. The proposals aim to tackle what the Commission considers as the main obstacles to cross-border e-commerce in the EU, namely legal fragmentation in the area of consumer contract law.

However, harmonising contractual rights for online sales only will create a de facto fragmentation between the online sales and the offline sales of the same good. The proposal seeks to reduce costs for businesses and strengthen consumer trust when buying online from another country, but it might have the opposite effect.

Having to cope with two different regimes for cross-border online and offline trade of goods would be a burden for omni-channel businesses and a brake on innovation for those aiming at an omni-channel strategy. Likewise, **a consumer might research a good online, experience the good in-store, and, after reflection, purchase it online for an in-store pick-up** – making contractual fragmentation between online and offline sales not only outdated but also incoherent.

The proposal for a Directive on the online sales of goods risks slowing down the innovation impetus in the retail sector and confusing consumers. The Commission actually foresaw this threat in its proposal and announced its intention to align the rules for online and offline sales of goods in the near future, in the context of its Regulatory Fitness and Performance Programme (REFIT).[1]

In light of the above, the Commission did not preclude the possibility that the results of the Fitness Check exercise on the application of the Consumer Sales and Guarantees Directive to face-to-face purchases of goods “feed into the progress made by the co-legislators on the proposal for online and other distance sales of goods.”

Recommendations

- ICSC urges the European Parliament and the Council to take these concerns into consideration when adopting the proposal for a Directive on certain aspects concerning contracts for the online & other distance sales of goods, and ensure consistency between the contractual rules governing the face-to-face and the online sales of goods throughout the EU.

2. Geo-blocking: how offline barriers nurture online restrictions

Unjustified geo-blocking and other forms of discrimination based on nationality or place of residence are considered contrary to the principles of the EU Treaty. Yet, there may be instances in which a different treatment is due to objective differences in the customers' situations, such as delivery costs, dissimilar VAT rates and diverging payment rules – to name but a few. By way of example, market access and operational restrictions play a role in stimulating geo-blocking practices.

[1] Proposal for a Directive on certain aspects concerning contracts for the online and other distance sales of goods, European Commission, 2015/0288, p.3

The extension and greater complexity of consumer journeys characterising omni-channel shopping behaviour have increased, rather than diminished the role of physical stores. Most retailers now realise that the physical store is the cornerstone of their overall retail operation. Strong synergies between sales channels have been evidenced by increased online sales in markets where the retailer opens a store.

Omni-channel business models lie in the fact that online and in-store sales benefit cumulatively from an integrated operation. Under these circumstances, the decision to resort to geo-blocking may lie behind disproportionate restrictions to retail establishment at national, regional or local level, which prevent a retailer to fulfil its omni-channel strategy in an optimal manner. The same goes for unjustified operational restrictions which hamper a retailer’s daily operations.

Retailers have shifted store expansion strategies to conquering principal cities, rather than countries, reflecting the greater marketing reach of flagship and major stores. The size of appropriate store portfolios will vary according to the scale of the market and the characteristics of the retailer with regard to sector and target audience.

Commercial and legal barriers in the offline world, in particular restrictions to retail establishment and operational restrictions, constitute a significant barrier to the development of cross-border e-commerce. Therefore retailers would have little incentive to resort to geo-blocking if existing barriers to cross-border trade were being addressed, and in particular, if the Services Directive was enforced.[2]

Recommendation

- ICSC believes that a thorough analysis of the retail landscape and the principle of contractual freedom, as well as a comprehensive assessment of the transformation the sector is undergoing, are a prerequisite for any regulatory action on unjustified geo-blocking.

3. VAT: sales channel does not matter

The fragmentation of the single market in 28 diverse fiscal jurisdictions represents a real obstacle for companies trying to trade cross-border both online and offline. As such, further harmonisation and convergence of the VAT systems, rates structure and levels in the EU is desirable, regardless of the sales channel.

The customer does not care where a purchase is made, but demands excellent incentivised service at all stages of the shopping experience. **Where a sale is booked is no longer an indication of all the factors that contribute to that sale**. Increasingly sales are being attributed to profit centres based upon the geographical reach of stores rather than by retail channel.

Very much like for sales contracts, having to cope with two different VAT regimes for e-commerce sales and for offline ones respectively would be a burden for omni-channel businesses. In addition, further fragmentation and distortion of competition – to the detriment of those pure players which do not aim at an online strategy – are to be expected from simplified VAT rules which would be specific to cross-border e-commerce.

Recommendations

- ICSC welcomes initiatives aimed at reducing obstacles to cross-border trade stemming from the fragmentation of fiscal rules in the single market, provided that all cross-border sales, regardless of whether the transaction has occurred online or offline, enjoy equivalent rules.

- ICSC calls on the European Commission to take these concerns into consideration when preparing the proposal on VAT for cross-border e-commerce, so that all businesses can benefit from simplified rules for VAT registration, calculation and declaration; easier access to information on each Member States' VAT systems; single audit methods for VAT purposes; and a single level playing field among intra EU transactions and imports from third countries.

4. Big data: it all comes down to the customer

With the advancement of omni-channel retail, digital is becoming fully integrated into every area of the value chain – so as the use of big data. Retail real estate owners have initially focused digital strategies on developing services that greatly enhance the customer experience, such as shopping centre apps which provide them with readily accessible information. Owners are investing in new technologies to help them better understand their customers' value and anticipate their wants and needs.

[2] Directive 2006/123/EC on services in the internal market

Innovative owners are using location tracking technologies, including Wi-Fi, beacons, and GPS/mobile devices – potentially collecting both personal and non-personal data by doing so, just like loyalty programmes by card. **Where customers with smartphones opt-in to a shopping centre system, owners are able to gain further insight on their increasingly complex shopping behaviour** by asking for information on a 'give to get' basis. These beacon captures allow owners to develop a much better understanding of consumers and their interaction with the centre.

The customer insight derived is also valuable to retailers within a centre and those considering opening a store. Most owners are using their analysis to strengthen relationships with retailers, and as a tool to explain and support asset management initiatives. Understanding synergies with other retailers and their relative performance within the centre is valuable knowledge to the owner.

By linking their stores to their website, mobile apps, and social media activity, the use of big data in the omni-channel world allows retailers to deliver a frictionless experience to their customers – raising data processing, ownership and privacy issues.

<u>Recommendations</u>

- ICSC welcomes the adoption of the General Data Protection Regulation that will improve legal certainty.

- ICSC calls on the European Commission to table ambitious initiatives to address the emerging issues of data ownership, interoperability, usability and access within the EU, so that both businesses and consumers make the most of the opportunities offered by the data economy.

5. Online platforms: brick and mortar is catching up

Regardless of whether an e-commerce platform acts as a marketplace, a retailer or both, it does not have the same needs as traditional retailers. In essence, what e-commerce platforms need is logistics for home delivery and collection, notably warehouses or pick-up points.

From a retail establishment point of view, **this may provide a competitive advantage to e-commerce platforms as compared to brick-and-mortar retailers, in particular if the e-commerce platforms are not covered by the scope of the retail establishment regulations**, as pointed out in a recent study commissioned by the European Commission. Yet, "the number of Member States that have adopted regulation including or imposing requirements for the establishment of such warehouses or pick-up points remains rather limited."[3]

In trying to integrate all aspects of their business models, brick-and-mortar retailers aiming at an omni-channel strategy seek to compete on equal terms with those e-commerce platforms. Integrating operations involve three major stages: 1) effective inventory management and tracking; 2) facilitating fulfilment as inexpensively as possible; and 3) integrating marketing and brand experience.

[3] Legal study on retail establishment through the 28 Member States: restrictions and freedom of establishment, Holland van Giizen Advocaten, project No. 2014.102, 2016, p.37

Most retailers are still catching up, with more experimentation required. Fulfilment, inventory and warehouse management, the keys to unlocking profitability, represent the top priorities for the majority of retailers, requiring considerable investment and a flexible regulatory framework.

Recommendations

- ICSC calls on the European Commission to take these concerns into consideration when preparing the best practices to facilitate retail establishment and reduce operational restrictions, so that brick-and-mortar retailers can compete on an equal footing with e-commerce platforms.

Retail is changing, so as the single market

The store still accounts for over 90% of retail sales in even the most mature online retail markets. It is generally believed that this percentage will decrease, as online retail sales gains continue to outpace those of in-store sales. However, focusing on sales allocation is misleading, and masks the complexity of the customer's decision-making journey and the symbiotic relationship across the physical and online sales channels.

The physical store is now viewed as a key to branding and showcasing products. This space must be experiential in a way that establishes the image of the retailer, while also showcasing its products in a way that drives sales. Whether the sale then occurs at the register, as an online sale picked up in the store, as a subsequent online sale, as an in-store online sale through a smartphone, or as a return/exchange of an online purchase, does not matter to the modern retailer and customer.

Omni-channel retail is a symptom of the ever-greater integration of the physical and the digital single markets. As omni-channel retail continues to evolve, the structure of the retail landscape will adapt and respond. Retailers are merging their physical and online platforms to increase total sales, lower costs and improve service levels to customers – and retail real estate owners provide the platform where online and offline retail can meet and band together.

Retail real estate owners are acting as an enabler for omni-channel retail, providing enhanced services for customers and assisting retailers with their distribution and fulfilment strategies by way of offering free Wi-Fi, centralised click-and-collect services and collection lockers for online retailers, etc. leading to a more collaborative approach between owners and retailers.

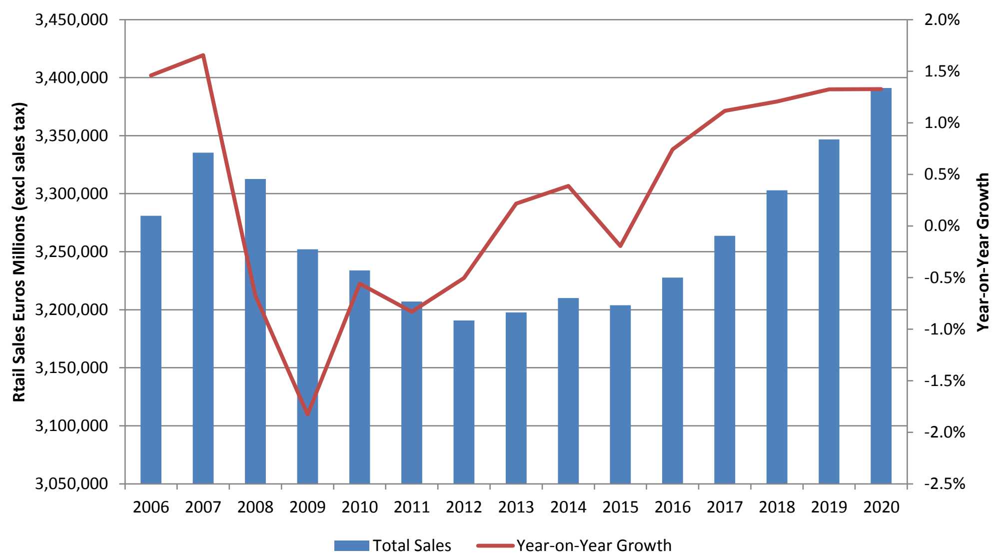
Under such circumstances, any legislative gap between the rules governing in-store sales and those governing online sales threatens not only to distort fair competition in the single market, but also to slow down the innovation impetus in the retail sector – driven by the omni-channel revolution.

THE TRUE VALUE OF EUROPEAN RETAIL REAL ESTATE IN AN OMNI-CHANNEL WORLD

Promising Sales Forecast for the European Retail Sector

Despite a turbulent decade with many seismic economic and political shocks, not least the global financial crisis and, more recently, the ongoing conflict in Russia and Ukraine and post-Brexit uncertainty, there is no doubt that the European retail market remains an economic powerhouse, registering strong sales of over €3.2 trillion in 2015 (**see Figure 1**).

Figure 1: European Retail Sales



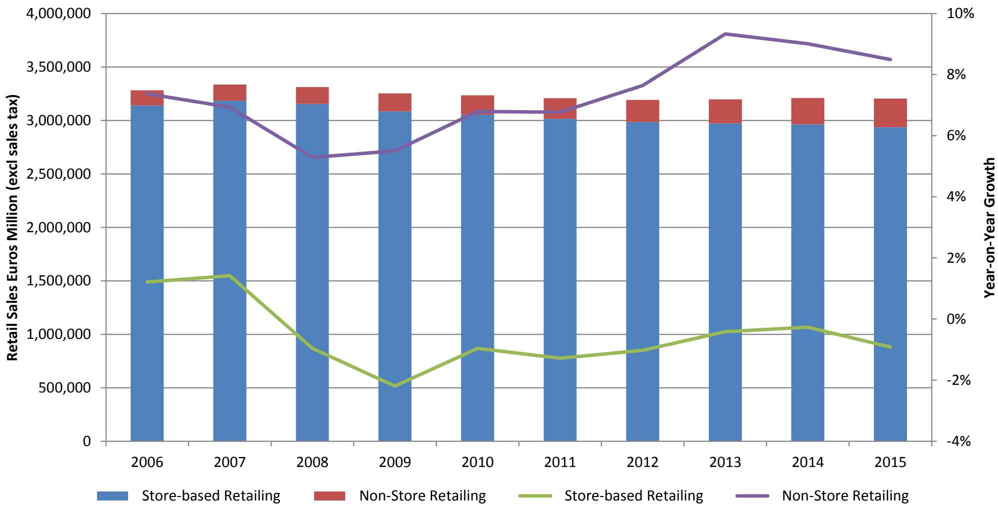
Source: Euromonitor

Whilst the outlook for the European retail sector as a whole is encouraging, with total turnover forecast to grow by 5.8% between 2015 and 2020, the retail real estate industry in particular has come under considerable media scrutiny with sensational headlines telling an apocalyptic tale that bricks-and-mortar is on a terminal downward trend and the Internet will eventually become the sole venue for commerce.

Store-Based Retailing Remains the Dominant Channel Despite Strong Growth in Non-Store Sales

Indeed, non-store sales continue to increase as a proportion of total retail sales and are growing at a rate that far exceeds that of store-based sales (**see Figure 2**); however, whilst growth rates are important, it is helpful to keep the overall levels in perspective and to be cautious when making comparisons between growth rates as non-store sales are calculated from a much smaller base. By euro volume, a small increase in store-based sales will dwarf a large increase in non-store sales.

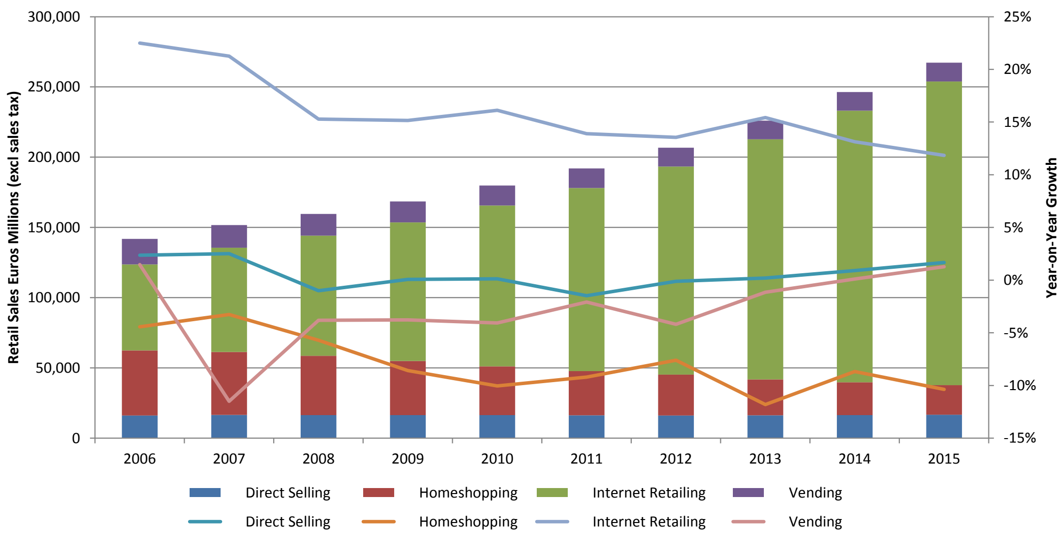
Figure 2: European Retail Sales – Store-Based & Non-Store-Based



Source: Euromonitor

Further analysis confirms that Internet retailing is indeed the dominant sales channel within the non-store segment, accounting for over 80% of all non-store retail sales in 2015, and is the driving force behind its rapid growth, with homeshopping on a continual downward trend and direct selling and vending seeing only marginal growth in recent years (**see Figure 3**). It should be noted, however, that the internet retailing component of non-store sales includes both pure-play and non-pure play retailers, which is discussed in further detail later on in the report.

Figure 3: European Non-Store Retail Sales



Source: Euromonitor

What is most important to acknowledge is that despite high levels of growth in Internet retailing, store-based retail remains the dominant channel for retail sales, accounting for 92% of total retail turnover in Europe in 2015, compared with 6.7% attributed to e-commerce. Furthermore, although Internet retailing continues to achieve double digit annual rates of growth, the pace of growth has consistently slowed over the past eight years, falling by 9.5 percentage points between 2007 and 2015 and currently standing at 11.8% y-o-y.

Omni-Channel Strategies Have Changed the Role of the Store

Whilst this is undoubtedly positive news for the retail real estate industry, in actual fact these statistics underplay the influence and contribution of bricks-and-mortar, with the impact of e-commerce on the retail real estate industry being habitually overstated and often misunderstood. The role of the store has fundamentally changed from driving sales in-store to also focusing on customer engagement, building brand image and driving revenue across all channels. The emphasis is no longer on where the transaction occurs, but on ensuring consumers have a seamless experience through the whole customer journey, pre-, during and post-purchase, as they research, compare, explore and review products and services.

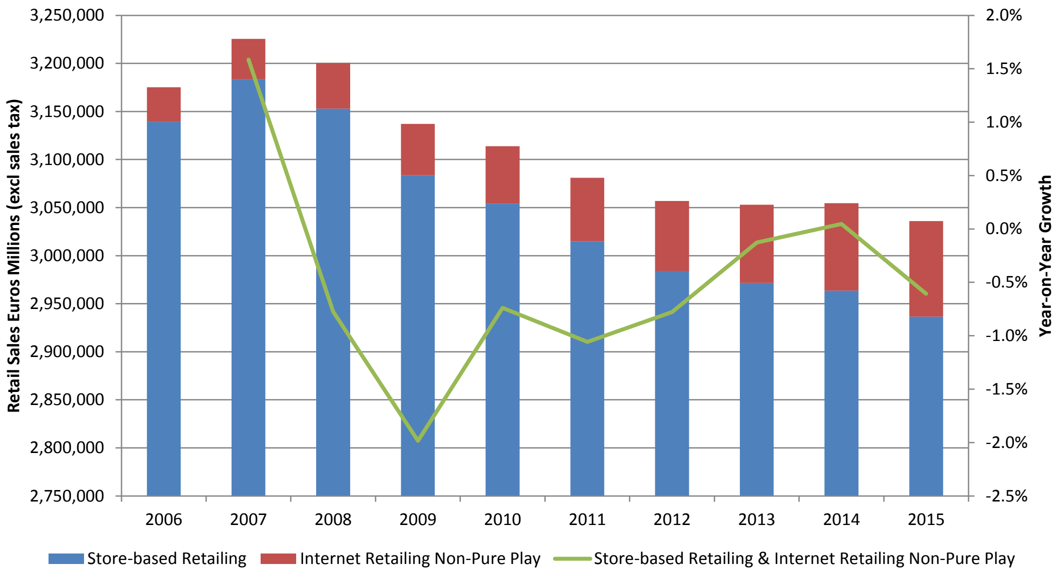
The key narrative here is convergence and the increasingly blurred lines between the online and offline world. Ultimately a sale is a sale irrespective of channel and, importantly, the store remains the cornerstone of omni-channel strategies for the majority of retailers, which is further cemented by the acceleration of ‘click & collect’ purchase models, offering consumers greater autonomy and flexibility than home delivery. Although the transaction takes place online, the store plays a vital fulfilment role – the value of which is often overlooked. Likewise, ‘showrooming’, whereby customers examine merchandise in-store and subsequently shop online, ‘webrooming’, that is researching products online and then visiting a store to purchase, or even online sales that take place within the store, whether it be on a mobile phone or via a store assistant with a handheld digital device, all highlight the halo effect of the store and the importance of bricks-and-mortar as a key touchpoint within the consumer journey.

The value of physical interaction with goods and customer service staff and the opportunity to provide more flexible fulfilment options and returns has not gone unnoticed and a number of previously internet-only or ‘pure play’ retailers have taken space in high streets and shopping centres. Indeed, of Internet Retailer’s ‘Top 500 European E-Retailers 2015’ only three of the top 10 are pure play retailers – Amazon.com, Zalando SE & Shop Direct. Even more telling is that, despite being an online stalwart, Amazon opened a physical bookstore in Seattle in 2015, with more locations planned in the coming months, and has recently announced that it is looking to further expand its brick-and-mortar presence with new grocery stores for Amazon Fresh subscribers.

Turnover Contribution of Bricks & Mortar Goes Beyond In-Store Sales

What is clear, therefore, is that in order to fully understand the value of physical stores, we must also consider the online contribution of retailers who have a physical store network. By challenging the top level e-commerce data and extracting the sales that are generated by bricks-and-mortar retailers via their online channels, Euromonitor data reveals that 46% of all European Internet retail sales in 2015 were attributed to non-pure play retailers, equating to €99.4 billion. When added to the sales that take place in-store, this means that over €3.036 trillion of retail turnover in 2015 is owed all or in part to physical retail real estate compared with only €116.8 billion in pure play e-commerce sales.

Figure 4: European Store-Based & Non-Pure-Play Retail Sales



Source: Euromonitor

Crucially, despite year-on-year growth of 13.9%, pure play sales accounted for only 3.6% of total retail sales in Europe in 2015, whereas 95% of European retail sales were carried out either in-store or online via a brick-and-mortar retailer.

Going forward, as physical retailers continue to invest in developing their omni-channel strategies, they will be a leading driver of e-commerce sales. As such, far from being a weakness, rising e-commerce sales testify to the strength of retail real estate and the enduring value of the store as an integral part of the consumer experience.

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