Retail sector leasing – Is a return to popularity on the horizon for turnover rents?

As the UK adjusts to life with Covid-19 and the impact this and government lockdowns have had on the retail sector, we are seeing more use of historic turnover rent structures (i.e. where rental payable by a tenant is determined not by a fixed sum but by reference to a percentage of their business turnover).

Read more below for key considerations of turnover rent agreements for both Landlords and tenants.

Are we seeing a turnover rents revival?

The recent increase in use of turnover rent models is a result of the uncertainty which still surrounds the UK business landscape and the ability to trade without varying degrees of restriction or lockdown and reflects concerns from both landlords and tenants around the sustainability of retail businesses and the impact the pandemic has had on demand for high street retail lettings.

The difficulty with the traditional fixed open market rental model is that, whilst predictable, it is quite inflexible and often – in a downward market – unsustainable for many businesses. As such, and to avoid a move to short term leases (which offer neither party, but in particular landlords, a great deal of security), many retailers are now looking to secure turnover rent obligations to take the benefit of the additional flexibility this offers. In essence, both parties effectively share in the risks (and rewards), ensuring, in theory at least, that tenants have a better chance of trading through a pandemic and landlords avoid empty premises/rental investment voids.

What are the options?

Whilst the idea of switching to a turnover rent model may sound reasonably simple, the reality is never as straightforward not least because there are a number of different turnover models available with no "one size fits all" option. Whilst calculation methods involve consideration of a wide range of permutations (often tailored to reflect a tenant's specific trading model), in basic terms there are two general models:

1. **"Pure" Turnover** – under which the annual rent payable will simply be a calculation of an agreed percentage of the tenant's gross turnover; and
2. **"Threshold" Turnove**r – under which the annual rent will be set at a fixed percentage of gross turnover but only where this exceeds a base rental which is payable irrespective of turnover; in other words, the turnover element effectively tops up the basic rental.

Key considerations

A first consideration is which model to adopt. The most commonly adopted model is the threshold turnover model, with the base rent usually set at between circa 70 – 80% of the open market value. This level of base rent ensures the landlord receives a reasonable "guaranteed" minimum rent. However, as the percentage set for the turnover element will obviously be dictated by the level of base rent (i.e., the lower the base rent, the higher the turnover percentage and vice versa) this is clearly negotiable depending on individual circumstances.

Interestingly, the return to popularity of turnover rents can arguably be attributed, at least in part, to arrangements imposed recently under various retailer company voluntary arrangements (CVAs) – including, for example, New Look and House of Fraser. It also appears there has been a wider softening from landlords willing to agree a turnover rent arrangement, possibly to seek to control the exit from the pandemic and to avoid forced CVA action or tenant insolvency.

The second consideration with turnover rents is how turnover is actually "captured", which can lead to some quite complicated workings and formulae. As this will obviously be the base from which the turnover rent is calculated, it is obviously important to consider both the outline terms and structure by which the model will work and whether the percentage is fixed or flexible depending on future market shifts, economic events and/or market trends. From the legal side, the agreement between the parties will need to reflect how the chosen model is to be implemented and how the rent is to be calculated. These arrangements may well lead to increased administrative and accountancy burdens in terms of bookkeeping and agreeing financial records/calculations.

In summary, whilst not without its complications, it would appear turnover rent is again seeing, and is likely to continue to see, a revival in the retail sector whilst the economy continues to navigate through the pandemic. Only time will tell whether this is embraced more widely or if simply used as a short-term solution to the immediate bite of the pandemic.

Next steps

Our large team of real estate experts advise on all aspects of commercial property, construction and planning law and have a solid history of helping clients structure, negotiate and complete commercial real estate transactions.

We have had experience advising on turnover rent models for both landlords or tenants and so can help you avoid pitfalls of these type of contracts. If you need advice, please contact Craig Burton for more information.

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