EXPLORING NEW LEASING MODELS IN AN OMNI-CHANNEL WORLD
ACKNOWLEDGEMENTS

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It is already clear that all aspects of the shopping center 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 center 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 realization 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 globalization, 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 analyzed 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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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 analyze 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 center 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 behavior. 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 center strategies to better anticipate and respond to consumer change. Realizing that it is no longer sufficient to offer accessible, well-designed centers 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 center 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 behavior within the center 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 centers 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 centers 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. **Percentage Rent Models (also called Turnover Models in Europe).** These types include:

   a. **Conventional percentage 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 sales once agreed targets are achieved. The difficulty with conventional 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 traffic and incremental spending to the center 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 neighborhood and mid-sized centers suggested, similar to leases implemented in European factory outlet centers, 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 properties. 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 percentage rent 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 nonstore sales data. Moreover, while many retailers are planning to shift towards merging online and store profit centers 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 neighborhood centers 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 sales.

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 center and individual occupiers, as well as new metrics to incentivize 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 traffic); 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.
New technology, in tandem with wider structural economic and societal macro trends, has facilitated and accelerated changes to consumer buying behavior. 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 center strategies to better anticipate consumer change. As a result, shopping center 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.

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 sales 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.

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, 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. Recognizing 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 center 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 center 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 center owners, as well as other industry experts. 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.
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.” 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.

Although the digitization 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. Beyond commodity-shaped goods, existing national and international retailers, especially those with an established catalog 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 behavior 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 behavior (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. Fulfillment 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 behavior.

**FIGURE 2.** Home and Mobile Internet Access, 2014

(Percentage of Individuals)

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.

Sources: M. Meeker, 2015 Internet Trends; Eurostat
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 centers and might be characterized by a high online sales component, for example betting shops, ticketing etc. The Center 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 centers (Figure 3). However, it is worth noting that as the data exclude food and beverage (F&B) services, which cannot be digitized, the online share of total sales may be overstated for total spending across shopping centers.

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 regionalization 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).

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

Source: Center for Retail Research
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 characterized 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

![Graph showing online sales growth and share for various retailers across different countries.](image)

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

![Graph showing percentage of population who bought online in the last 3 months and those who never bought online.](image)

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

Source: Eurostat (2015) ibuy survey
Given the symbiotic relationship between online, in-store and other channels such as catalog sales, retailers are shifting away from separate profit centers. 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, fulfillment 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).

Source: Eurostat (2015) ibuy survey
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.

Omni-channel shopping behavior requires retailers to mature from multi-channel platforms to an omni-channel organization, which requires a considerable investment in inventory management and information tracking systems.
Shopping behavior 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 capitalize on technological change.

This reorganization permeates every aspect of the business. In addition to organizational transformation, the evolving omni-channel retail model also has significant impacts upon store portfolios’ optimization 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.º

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 strategy¹⁰, 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. Fulfillment 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 centers 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. Fulfilling such promises, whether made in-store or online, is essential to building customer loyalty and trust. Hence, inventory management and fulfillment are a major focus for many retailers’ capital expenditures currently.

2. **Facilitating fulfillment as inexpensively as possible.** Fulfillment 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 fulfillment 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 favoring growth over profits. 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 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 program 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 centralized 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. 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 behavior 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.
To achieve this requires business accounting and profit centers to be reorganized to better reflect the omni-channel business. The customer does not care where a sale is booked, but demands excellent incentivized 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 centers based upon the geographical reach of stores rather than by retail channel.

3.2 Store Portfolio Optimization

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 rationalizing 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 centers in Spain and in non-prime high streets in the U.K. (In Europe, high streets generally mean main street retail. The same term in the U.S. instead refers to upscale streetfront retail.) 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 centers, particularly those located on the urban periphery.

This has led to retailer and investor retrenchment to prime locations, destination shopping properties and retail centers 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 centers 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 center rental levels increased by 7.0% since the previous market peak in 2007; growth in secondary shopping center 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 pie in Sweden than to get a bigger piece of a smaller pie 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. 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 polarized store portfolio strategies. Securing good quality space in perceived “A” locations, including large, destination shopping centers 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 theater 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 centers. In addition, excess space in these stores can provide localized fulfillment 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 maximize the utility of a consumer’s time.

### 3.3 Purpose and Value of the Store

The extension and greater complexity of consumer journeys characterizing omni-channel shopping behavior have increased, rather than diminished the role of physical stores. Most retailers now realize 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. Recognizing this, many pure-play retailers have and are opening physical stores to enhance their brand.
The major shopping center 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 specialization, place-making and digitizing the business model.

### 4.1 Portfolio Specialization

Mirroring retailers, the demand for shopping center investments has polarized between large, destination centers and, neighborhood and convenience centers. In the U.S., demand is also strong for both types of centers, although investors segment these types. Demand is somewhat different, however, for secondary centers and secondary locations with weak performance. While retailers have developed stratified portfolios, owners have rationalized portfolios and tended to specialize 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 centers are particularly favored by the largest shopping center owners and investors. In both regions the ownership of destination and experience centers 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 specialize in destination retail and engaging consumers with stimulating environments and experiences, supported by outstanding customer service and facilities that maximize the utility and quality of time. In managing these capital-intensive properties, owners are increasingly establishing a recognized brand of ownership for the center 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 specializing in convenience and neighborhood centers is identifiable. These centers 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 maximize the utility of time for consumers through ensuring that the experience of fulfilling consumer needs and requirements is convenient, easy and supported by excellent service. This includes the co-location of appropriate services. Stronger centers are typically owned by public and private companies quite separate from the large destination center owners and by other institutional investors.

Beyond the spectrum of experience and convenience, retailer demand for mid-sized centers in Europe has been considerably lower. The impact on pricing has resulted in low capital investment for many such properties. 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 properties in competitive catchments may be challenged, other centers in stronger catchments that benefit from a more dominant position may simply require re-positioning within the new retail hierarchy.
4.2 Shift from Space-Making to Place-Making Strategies

Many owners recognized 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 upscale streetfront retail or downtowns, and the emergence of lifestyle centers. 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 center 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 center 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 center owner provided a well-located and -designed venue for appropriate retailers. The owner managed the tenant mix to drive consumer traffic and sales. Management focused on understanding the agglomeration economics of co-tenancies in order to maximize 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).
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-oriented 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 maximize time will underpin customer experience. Strategies, again, will differ across different center types and customer profiles. For example, convenience-led centers may co-locate civic or other non-retail services within a non-core retail space in the center, reducing the time that customers require to undertake chores, as well as placing retail near where consumers have to be. Equally, leisure-based shopping centers 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, personalized services, centralized 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 traffic (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.
While 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 Digitizing the Business Model

The evolution of the role of technology within shopping center 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 summarized 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 center app, with or without an associated loyalty program. 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 parking lot 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 maximizing time.
4.3.2 Enhance Sales

Shopping center apps that provide customers with readily accessible information have been quickly recognized 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 center entrances, at entries to stores, in hotspots within centers, intercept interviews and focus group sessions. Established systems for counting shoppers at entries have numerous accuracy problems. 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). 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 center. 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 center. A limitation of the technology at this point is that it is only accurate within a 7-meter/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 center 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 analyzed 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 center 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 center 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 center 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 center, 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 center 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.

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 centers on a 24/7 basis.

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 centers.

However, emerging tracking technologies greatly increase the value of transactional websites to owners, by furthering the understanding of the omni-channel behavior of customers and most importantly, their spending patterns. Linking this to shopping center 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 center 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 center 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 capitalize 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 center.
Throughout Europe and the U.S., macro trends, including and facilitated by technological change, are transforming the shopping center 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 center 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 centers, although the implications for tenant mix vary with the type of center. 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 centers. The proportion of GLA dedicated to this use in European shopping centers has already increased from 11% to 15%, with new developments and renovations indicating a further rise to 20%. In the U.S., higher-quality malls and lifestyle centers are at the higher end of this range and open-air centers at the lower end, and both are growing. This increasing allocation of space to F&B is very important to destination and experience centers. Until relatively recently, the role of F&B within a shopping center 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 traffic to destination and experience centers. As a consequence, it is not merely the quantity of space that has altered, but also the range and higher quality of operators.

Shopping center owners and managers are enhancing the F&B component of the center 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 centers 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 center’s consumer appeal fresh.

Specialty leasing has become a much more prominent component of a center’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 center.

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 center, 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, recognizing 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 centers, 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 center marketing strategies can anchor to further enhance appeal.

Within European convenience and neighborhood centers, highly regarded local 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., neighborhood and community retailer centers 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 centers are also increasing allocations to leisure and entertainment. Attractions, including pop-up varieties, are being used to drive traffic and extend dwell time. Similarly, certain specialist retailers that have a strong brand and innovative entertaining store concept, yet low affordability, are also recognized as providing a valuable point of difference for competing centers. 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 recognized.

The provision of more favorable lease terms for retailers that generate very strong consumer traffic 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 centers is also improving owners’ understanding of the contribution of individual retailers to the center. Owners and consultants commented that a number of retailers that benefit from attractive lease terms do attract strong traffic to their stores, but customer analytics suggest that there is little evidence of synergy with other retailers across the shopping center. More granular analysis of customer flows allows owners to better understand the synergistic value that individual retailers bring to a center in addition to their analysis of direct sales.

Place-making is at the heart of re-engineered shopping center strategies and owners are integrating services into the tenant mix to deliver on experience and convenience. In destination centers 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 centralized shopping services that are used to help customers maximize the quantity and quality of time.

In the U.S., owners of open-air centers are also adding amenities including gathering areas, increasing F&B including popular fast casual dining, coffee bars, fitness centers, and unique and interesting retailers. In some cases, fashion retailers who traditionally locate in malls can be attracted. In the U.S., power centers, 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 neighborhood centers and in U.S. neighborhood and community centers, 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 center at the heart of the civic center.
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 traffic 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 neighborhood centers 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, colors 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 fulfillment.

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 centers, 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 amortization.

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 neighborhood or community retail centers 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 centers 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 favorable 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 build-out costs to sales, which requires amortization over a longer period of time. Major retailers usually amortize 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 center’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 center.

Owners provided a different perspective, arguing that the capital costs and funding requirements of development and renovation 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 centers 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, characterized by fickle consumers and ever-shorter brand lifecycles.

Indeed, a number of owners are viewing the income profile of the center as a portfolio and are keen to optimize 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 forgo 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 centers in Europe, particularly if the variable income component of rental models were greater. A number of retailers commented that in certain circumstances, the center and the retailers it accommodates would benefit from the ability to terminate a poorly performing retailer in an otherwise strong property.
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 fulfillment; 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.

Fulfillment of digital retail presents opportunities for a range of new services. Owners are considering or are providing click-and-collect lockers and/or centralized fulfillment locations in the shopping center. These services can provide an additional revenue stream. Some owners have also recognized that some retailers require greater storage/logistics space and are creating such space in otherwise underutilized 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 center helps customers to curate and manage multiple retail interfaces more easily. Most owners stressed the importance of designing shopping center 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. Most owners are at the early stages of harnessing their data and are primarily using it to develop new performance benchmarks for individual centers 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 commercialization of their customer insight and digital infrastructure to digital advertising media, which can respond dynamically in real time to the customer opportunity.
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 centers 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 centers, leasing managers will understand the performance of comparable retailers within the center and in other centers for which they have lease information. In addition, they will derive the rent-to-sales ratios of the target retailers in similar centers and also understand the occupancy costs (rent plus pass-through expenses and amortized 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 center's market share of spending in the catchment. Equally, retailers will consider competitive centers as well as any potential sales cannibalization 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 behavior, 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, average 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 center companies, these top-off rents range from 0 to 10% percent of base rents across portfolios, although there can be significant differences between centers 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 percentage rent models is only one beneficial aspect of reported sales. The ability to measure the performance of the center 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 centers, 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 characterized by fixed rents without an accompanying variable component related to performance. These models also dominate leasing practices for high street units and retail parks (i.e., power centers) 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 percentage rent models has become an increasingly common alternative to the practice of fixed rents for U.K. shopping centers.

6.3 Omni-Channel Challenges for Rent Models

The speed of transformation for both retailer and shopping center 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 digitized business models and performance metrics. For example, in Europe a number of sub-anchors (generally known as junior anchors in the U.S.) have sought to capitalize on the strength of their brand where possible. Beyond the top tier of destination centers where demand for space exceeds supply, certain such retailers have sought percentage-only leases on very favorable terms.

Although driven by economic fundamentals, these lease arrangements have highlighted the limitations of rental capture within current percentage rent models, with or without an accompanying base rent. This is because the same retailers are also pursuing omni-channel strategies that seek to maximize 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 center owner, the definition of sales 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

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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 centers for in-store and online, although this is rapidly changing. 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 center 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 recognize they need to better understand the store's contribution to the bottom line, but this is clearly a work in progress.
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 recognized 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 centers are used to showcase the brand’s values and products, and to meaningfully engage customers in the brand experience through retail theater and relevant customer services. This showcasing generates brand value for future or repeat business, in addition to immediate sales.

Stores within convenience, neighborhood, community, or power centers are often concerned with convenience and attentive, yet efficient customer service. Nevertheless, even with these more convenience-oriented centers, 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 sales 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 recognize that retailers with a strong omni-channel business that use click and collect as a significant fulfillment option can be a driver of traffic and incremental sales to the center. 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 traffic and incremental sales generated for the shopping center represent a net benefit captured at the store’s POS.

A number of owners, especially of destination centers, contend that the contribution of the store to the retailer’s ability to fulfill online customer orders should be recognized 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 fulfillment 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 fulfill online orders through stock picking within the local store. Thus, there are no cost savings for fulfillment 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 fulfillment 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
sales. The percentage rate was much lower than that usually agreed for store sales in shopping centers. 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 fulfillment. 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 sales 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 color, 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 center 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 centers. This evaluation of a range of possible approaches provides a useful toolbox for selecting and devising current and future rental models.
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, percentage 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 centers 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 center 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 favor 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 recognizing 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 Percentage Rent Models

Many owners and most retailers favor percentage rent models (also called turnover rent models in Europe). 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 incentivizes 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-based models may be categorized into three broad groups: conventional percentage models, European factory outlet center-style models and geo-fencing models that draw from airport retail models (see Figure 17).

**FIGURE 17. Percentage Rent Base Models**

### 7.2.1 Conventional Percentage Rent Models

Conventional percentage rent models include a base rent accompanied by a variable income calculated as a percentage of sales achieved above a certain threshold. Commonly utilized in the U.S. and continental Europe, base rent comprises from 90% to 98% 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 centers, 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 percentage 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 center’s performance. It becomes a key tool in lease negotiations.

Indeed, recent analysis of the sales and rental performance of centers reveals a negative relationship between sales productivity and net asking rents, suggesting that the variable performance component of rent captures growth. Although the analysis is not broken down by type of center 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 percentage rent model. However, they commented that while sales levels in their shopping centers 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 percentage, as hinted earlier.
Percentage rent models can become attractive options in second-tier centers, where demand for space may be much lower than for destination centers. 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 center, 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 centers than in highly competitive first-tier centers. 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 center-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 centers.

7.2.2 European Factory Outlet-Style Leasing Models

European owners of some neighborhood and also of more challenged mid-sized centers suggested rent models more commonly associated with European factory outlet centers. These involve a percentage rent model, usually including a lower base rent than for conventional percentage 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 center 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 centers have negotiated percentage-only leases in neighborhood and second-tier centers 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 traffic and sales across the center, given the very low performance component of rents. In short, while the performance element ensures that income can increase if the center performs in line with or better than expectations, it cannot decrease if it underperforms, excepting, of course, tenant default or rental revisions.

Most retailers recognized 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 percentage 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 percentage 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 favoring fixed rent, conventional percentage of sales 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 Store Sales 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 centers, 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 center 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. Of course, additional costs associated with operating a digitized 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 favored 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 behavior and type of product, these owners would apply different percentage rates 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 rate applied, while a non-store online transaction would apply the lowest percentage 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 fulfillment, but also the additional costs of achieving the sale to the retailer and the value of click and collect to the center. 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 recognizes the variable contribution of the shopping center to the wide range of customer journeys is favored by many owners, although most thought that retailers’ reluctance to share data would be a barrier. Although many retailers recognize 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 center, 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 jewelry 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. 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 fulfillment and showcasing product has increased.

7.3 Use of Alternative Performance Metrics with Leasing Models

A number of owners of both destination and neighborhood centers 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 centers 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 incentivized 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 sales.

While 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 center and individual occupiers, as well as new metrics to incentivize 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).
7.3.1 **Net Shopping Hours**

Traffic and customer flow are monitored by all the major destination shopping center owners interviewed. However, tools for measuring these range widely in sophistication and accuracy. Such measurement, not often found in neighborhood and community centers 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 center 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 percentage rent catch-up metrics.

Some owners of neighborhood and larger convenience centers in Europe favored this approach. These owners are focused on developing asset strategies and marketing initiatives that increase the number of visits to the shopping center 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 centers 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 traffic. 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 center apps or other digital media operated by the center.

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 properties, 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 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. 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 behavior 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 traffic, 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 center as an entity where traffic 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 center 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 center. 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.

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 renovate or replace them. Appropriate solutions will vary between different types of centers 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 centers; after all, necessity is the mother of invention. The toolbox emerging from this research aims to provide a wide range and spectrum of alternatives, organized 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.
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 center 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
AirAge
Altaarea Cogedim
Appeal 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
MLV & Co
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!
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. See “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.


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.


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.


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 cannibalizing 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-oriented retailer, for every $1 in sales captured online, only $0.35 was cannibalized 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 or sales percentage.


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

