Retail Real Estate: The Next Normal

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Traditional retailing has been going through significant transformation over the last two decades. Whilst this process has been accelerated by the COVID-19 pandemic we don't yet know what the new 'normal' will look like for the industry. Nonetheless, we will explore in this article some key trends which we believe will have lasting implications on retail businesses.

The rise of omnichannel

Traditional retailers relied heavily on a single channel retail model. As such, they focused their resources and capabilities on either the offline channel (i.e. physical stores) or the online channel. Both channels used to be viewed as competing with each other. The key concern from a retailer perspective was that if the customer becomes adapted to the online channel, it will abandon the in-store experience and will 'migrate' to the online channel. The pandemic has accelerated improvements in payment and distribution systems which, in turn, have enabled online channels to increasingly compliment the in-store channel. Today, creating a seamless experience over different channels, while at the same time ensuring accuracy and efficiency in execution, is within the realm of the possible. To 'win the future', retailers and vertically integrated brands need to take a holistic view of the advantages of having a physical presence and double-down on their multi-channel capabilities. It is by no means the end of the traditional 'bricks-and-mortar' store. Physical stores will remain a key element of the formula and successful retailers will be those who will get the right configuration of omnichannel capabilities.

New landlord-tenant dynamics

The pandemic has no doubt introduced a paradigm shift in the landlord-tenant relationship. Widespread economic shutdowns have forced many retail tenants into challenging conversations with their landlords, with the outcomes poised to change the retail real estate landscape. The next era, we expect, will be one of an increased co-operation and data-sharing between landlords and tenants as both parties realize that they are in a form of business partnership. This will pave the way for further trade-offs during lease negotiations. Retail tenants will seek (or hold on to) the turnover rent concept (in some instances pushing back against the base rent construct altogether). There will be shorter lease terms, and more flexibility around exit options at agreed break fees. It will not be surprising to see "go-dark" (or "go-dim") clauses included in retail leases to allow tenants, upon the occurrence of certain triggering events, to completely cease operations (or reduce operations) at the premises without being in default under the terms of their leases. On balance, we expect that, rather than holding on to an outdated leasing model, landlords and tenants will increasingly recognize their mutual interests and strive to align their revenue generating strategies.

Emergence of the management model

Continuing with the above theme, and as an alternative to the traditional lease structure, we expect that there will be more demand in the retail space for a management model to structure the relationship between owners and occupiers. Under a management model, the owner would appoint a qualified and experienced retail operator (e.g. cinema operator, renowned chef, etc.) to manage and operate the space on its behalf. This model borrows from the concept of management agreements in the hospitality industry. The owner would provide the space, the necessary funds for the fit-out works and the working capital whilst the retail operator would take on the overall responsibility of managing and operating the business on behalf of the owner. Revenue and profit would be distributed in accordance with a pre-agreed formula that would keep the operator incentivized. The benefit of similar arrangements is that, when structured properly, they can allow the parties to work together without the need for the owner to grant a leasehold interest in the property to the operator. Having said that, the adoption of a management structure instead of a traditional lease structure will depend significantly on the risk profile of the owner. Risk-taking owners and high-return oriented investors such as private equity firms may find the management structure more appealing in light of the potential income stream. Risk-averse investors will be more attracted towards the traditional lease structure which, despite a lower return, can generate a predictable and steady cash flow.

New satellite retail centres

The pandemic has stimulated a physical movement of consumers away from traditional retail environments. With more employees working from home, it would not be surprising to see retail footfall decreasing in central locations and becoming increasingly scattered to suburbs. The retailer of the future will need to adapt to new market dynamics and potentially relocate or expand its business to emerging satellite centres in order to capture value. For this to happen, policy-making initiatives will need to support this trend by providing the appropriate infrastructure.

Retail real estate and the Metaverse

The last trend is one that is the subject of much current debate. Digital twin stores are innovating the retail sector, with the promise to solve logistical issues for the real world and replicate the in-person shopping experience. As major brands and industries continue to deploy substantial investments in nonfungible tokens and participate in their trade, the Metaverse is evolving in its potential for revenue and opportunities. According to MetaMetric Solutions, real estate sales on the four major Metaverse platforms topped USD 500 million in 2021 with sales projections for 2022 exceeding USD 1 billion. Proponents of the Metaverse argue that this is simply the start of a major transformation. Critics see it as not more than a massively overhyped concept that will be a regulatory minefield going forward. Whilst, in our view, badging such assets ‘Real Estate’ is not a natural fit, we do believe that, given the impact that the Metaverse has on consumer behaviour, retailers may need to watch this space, and potentially ‘get on board’ to reap the benefits.

Closing thoughts

There are myriad of headwinds focussing retailers on the here and now. COVID-19 remains a key concern for retailers with the challenges presenting a nasty hangover (e.g. new variants, supple chain issues, etc.). That said in the meantime, the new ‘normal’ is taking shape. Retailers that want to retain a competitive edge need to consider some (if not all) of the above emerging trends. The future belongs to the retailers who are able to anticipate market trends and respond to them with agility and innovation.

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