

Turnover rents – A checklist for landlords

Turnover rents in the retail sector have been around for years. Since the 2007/2008 financial crisis, turnover leases have been on the rise, and the spate of CVAs in recent years has seen many turnover rent arrangements imposed on landlords. In the current pandemic turnover leases are once again on everyone's agenda, and not just in the retail, F&B and leisure sectors. Even the office sector is looking at turnover rents. The model is being promoted by many as the best solution for the future of the retail sector, but there are several issues for a landlord to consider to avoid delays and difficult negotiations.

The “who” questions

Turnover percentages and any turnover thresholds will be agreed based on a tenant's projected turnover figures. As a starting point, turnover provisions should be personal to the tenant in actual occupation of the premises.

Tenants may require turnover provisions to benefit group companies, in which case you should consider the user of each group company before agreeing, as different uses may require different turnover percentages. Also bear in mind that a tenant's group companies can change during the term of the lease.

It is standard practice not to permit underletting where a lease includes a turnover rent. If a tenant insists on being able to underlet, get the tenant to agree to the turnover provisions falling away if it does so.

Turnover Checklist

When agreeing turnover rents consider these key points:

- **Who?** – Who will benefit? Only the tenant in actual occupation or will group companies and/or successors in title benefit too?
- **What?** – What should count as “gross turnover”? What base rent should be paid (if any)? What turnover percentage(s) and threshold(s) should apply?
- **When?** – When should the turnover rent be paid, in arrears or in advance, and monthly, quarterly or annually?
- **Where?** – Where should the turnover arrangements be documented? In the lease itself or in a personal (and confidential) side deed?
- **How?** – How will the turnover provisions be enforced? How will the turnover arrangements impact on the wider lease terms?

The “what” questions

There are two types of traditional turnover models: the base and turnover model and the turnover only model.

The definition of “Gross Turnover” is the subject of the most negotiation between landlord and tenant. Much of the definition has become “standard” over the years, but this is not always the case when it comes to on-line sales, the return of items purchased on-line and “click & collect”.

It is now generally accepted that orders made via the internet on in-store devices should be attributed to that store’s turnover. Including on-line sales where the order is fulfilled from stock in-store (whether or not the order is made from devices in-store) will also be acceptable in most cases. However, a tenant will want to exclude those sales where the order is fulfilled from stock at warehouses or other stores.

A tenant will usually require an express deduction for on-line returns and for returns made at the premises but from sales concluded at other stores. However, with a few exceptions, most tenants will now accept that where they are not entitled to the income from on-line and “click & collect” sales, they are not entitled to deduct the returns of similar items either. The difficulty for a landlord is how to police what tenants are doing, and landlords are unlikely to want to audit every tenants’ figures every year.

The “when” questions

Where a base rent is reserved, a tenant will pay the base rent quarterly or monthly in advance. In respect of the turnover top up element, you may be prepared to accept turnover rent payments in arrears, perhaps on an annual basis after the reconciliation has been completed, but only where the level of base rent is significant and the turnover element is more of a “nice to have”. If, as anticipated, the market sees base rents reducing and turnover rent elements increasing, this is unlikely to be palatable for landlords, and regular on-account payments (even if in arrears) should be required from tenants.

Where the lease is a turnover only lease, on-account payments, either monthly or quarterly, are the norm and should remain so. These will usually be paid in advance and based on the previous year’s turnover rent, with specific on-account payments for year one agreed with the tenant (and based on the tenant’s projected turnover) as part of the heads of terms negotiations.

Turnover periods do not have to be 12 months and can be for shorter periods. Although shorter turnover periods can be helpful where a tenant will only agree to pay turnover rent in arrears, they potentially increase the administration time involved for landlords, as well as the cost of managing the whole process.

The “where” questions

You should consider including turnover provisions in a confidential side deed rather than the lease itself, precluding future tenants from using them in negotiations. This will be particularly relevant where the lease term is more than 7 years as the lease will be registerable at the Land Registry and publicly available. The side deed should be drafted on the basis that it falls away on any assignment or underletting of the lease.

Confidential side deeds are also useful when it comes to mitigating the impact of turnover rent arrangements on open market rent comparables. Too many publicly available turnover leases could have an adverse impact when rent reviews come round!

Prohibiting alienation in the lease itself will, however, impact on other lease terms, particularly rent review. If the base rent is to be reviewed, stepped increases or index linked reviews will be preferable to open market reviews.

The “how” questions

A keep open clause requiring a tenant to trade at certain times is a necessity in any turnover arrangement. The lease or side deed must cater for the situation where the tenant is in breach of the keep open clause.

In such cases a substituted (or deemed) turnover will be applied as a daily rate for each day the premises are closed. Usual carve outs to a keep open covenant would include reasonable periods for stock taking, permitted assignments and alterations, and Government mandated closures.

You should also provide for any failure by the tenant to deliver its turnover information. Without this, you will not be able to calculate the turnover rent due and issue your rent demands. Landlords should consider which default position will be the most appropriate in the circumstances.

Examples include the level of the base rent (if there is one), the full open market rent, or the landlord's estimate of what the tenant's turnover should have been. Take care if a tenant suggests a default position based on its previous year's turnover as, in subsequent years, a tenant could well benefit from its previous failures to keep open. The default amount should be significant enough to provide a real incentive to comply, but not so high as to punish inadvertent delays or to amount to a penalty.

The permitted use in a lease must also be reviewed with reference to the agreed turnover provisions. The turnover projections provided as part of the initial negotiations will be based on the tenant selling specific products or providing specific services. A wide user can provide flexibility and therefore maximise turnover, but it can also undermine a landlord's tenant mix. If the user is unduly restrictive, it may prevent a tenant achieving its original projections. Where change of use is permitted, it may be reasonable for a landlord to withhold consent if the proposed change could adversely impact the amount of turnover rent it might expect, but this will depend on the circumstances and the wording in the lease, so think about this at heads of terms stage if such controls are needed. Also be aware that a change in the products sold or services provided may mean a turnover percentage initially agreed is no longer appropriate.

Conclusion

Turnover rents have previously been viewed by many landlords as a short-term measure, used more in times of recession to get vacant units let, to try new brands and, more recently, because CVAs have demanded it. The impact of Covid-19 has led to many within the industry predicting that the use of turnover rents will become more widespread, but will the traditional turnover models and their use evolve with these changing times (see box opposite)?

What the future may hold for turnover rent models

- **New Flexibility** – A key benefit of turnover rent is the ability to customise. Landlords should not apply a one-size fits all model. Account should be taken of all factors, including tenants' businesses, property locations and lease terms. Many elements (including turnover percentages, turnover thresholds and base rents) can be varied from tenant to tenant or year to year.
- **New Sectors** – Turnover rents have traditionally been most common in the retail sector but they are now being used in the flexible workspace arena. As we rebuild, turnover rents may be applied elsewhere. Covid-19 has forced traditional industries to become much more agile.
- **New Models** – With concerns about the quality of turnover information being supplied to landlords, the introduction of third-party determination for disputes is likely. Data analysts could be used to set turnover percentages and thresholds, based not just on attributable turnover, but also taking account of on-line sales, return rates and footfall, providing more transparency for all. Where turnover thresholds are not met, landlords could look to the outlet model for solutions or simply provide for personal turnover arrangements to fall away.
- **New Definitions** – Tenants may seek to move away from the traditional definitions of "gross turnover" to those more reflective of EBITDAR. Alternative models include leases based on "total occupancy costs", where higher fixed rents provide tenants with greater certainty by eliminating unexpected costs, but landlords will need to be able to cost the fixed rents as accurately as possible.
- **New Risks** – As the move to on-line sales continues, the biggest risk for landlords, based on the current turnover model, is their properties simply becoming showrooms, with little or no turnover actually being generated from them. For the turnover model to remain appropriate, the definition of "gross turnover" will need to start catering for such an eventuality.

Turnover rent arrangements offer flexibility and an opportunity for landlords and tenants to work in partnership. They can benefit both parties, but the key message is to think about the detail from the outset. All too often, heads of terms simply state the agreed turnover percentage and any turnover thresholds, with the other terms *"to be agreed between lawyers"*. This invariably leads to delays and difficult negotiations which can be reduced by considering the questions we have set out in our Turnover Checklist.



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