

SLAUGHTER AND MAY

Slaughter and May Podcast The retail sector - looking forward

Graham Rounce	<p>Hello, and welcome to this Slaughter and May Podcast. I'm Graham Rounce, and I'm delighted to be joined by David Kozak, Head of Real Estate, Construction and Engineering law at Ocado. David is also Chairman of the British Retail Consortiums Property Committee. We are joined by John Nevin, one of the partners in our Real Estate group. John has worked with David on a number of matters including helping with the expansion of Ocado's distribution portfolio. Following on from our look at trends in the office market, we are going to consider the retail sector.</p> <p>David starting with you first if I may, thank you very much for taking the time to join us. Are you able to summarise the immediate impact of lockdown on the retail sector.</p>
David Kozack	<p>Indeed well thank you very much for inviting me. There are two parts to this answer: there's the physical impact and then there's the financial impact. So let's look at the physical side first. We saw the enforced closure of stores, staff being furloughed and almost empty high streets and shopping centres. Then after many weeks we've witnessed a gradual reopening of stores, but that look different. We've seen the introduction of plexi-glass screens at the tills, social distance marking on the floor, restrict occupancy levels, the enforced wearing of masks and hand gel stations being located at strategic locations.</p> <p>Now on the financial side the BRC estimates that lost turnover totals around £1.6 billion during lockdown, footfall is currently now 50% of pre-Covid levels and footwear and fashion have been especially badly hit.</p> <p>And last but certainly not least is that retailers have found themselves in difficult situations when it comes to the payment of rent, insurance and service charges.</p>
Graham Rounce	<p>Thank you David. Following on from that, has online shopping in any way compensated for the loss of physical sales?</p>
David Kozack	<p>It has to an extent Graham. Online non-food sales rose from around 30-40 per cent and are staying at that level so it's certainly accelerated the trend towards more online purchases even as shops have re-opened. Now on the food side, the market grew incredibly strongly, as we witnessed significant migration to online shopping and what we can extrapolate from this now is that for some retailers, their online offering has been a lifeline.</p>
Graham Rounce	<p>Thank you, now, turning to John if I may, has the Government's Code and the measures to prevent enforcement action against tenants been effective?</p>
John Nevin	<p>Thank you Graham – I think as far as the Code is concerned, as we all know that's a voluntary code and so it's debatable about the extent to which both landlords and tenants have adhered to that or that we could point to the Code as being responsible for tenant or landlord behaviour in this area, but certainly the area that has been enormously effective is the legislation that the government has brought in. In</p>

	<p>particular, I would point out the suspension of the landlord's rights, the traditional armoury of the landlord's rights being the right to forfeit a lease when the tenant doesn't pay its rent and indeed the right for a landlord to serve a winding up petition on tenants where they have accrued debts which remain unpaid. And so it's undeniable that the purpose of this legislation was to enable businesses to continue in operation and I would say that it has been effective.</p>
David Kozack	<p>I think, could I possibly add something to that. I think that BRC members' research has a consistent figure of around 30% of landlords not engaging or not doing so in the positive way that the government would have expected, and that really hadn't shifted since the introduction of the Code. And I think although certainly there have been positive steps, I think the moratorium should be extended and I think it would be unfair to remove it before Christmas, or the New Year sales because that's the retailer's opportunity to try and recover some ground, which means that probably the March quarter day would arguably be a fair time to lift the moratorium.</p>
John Nevin	<p>Yeh, I think that Graham it's worth adding to that that we have seen somewhat of a theme between certainly in our experience, the smaller tenants tending to be the ones who are engaging with landlords and the larger businesses, you know sometimes private equity owned, the ones that are perceived to be with deep pockets being less inclined to engage with landlords. And we've seen some, you know well publicised cases there involving hotel chains etc. where we will undoubtedly see some significant court action. And I certainly agree that those who can pay should pay, but effectively these government measures, as we know, do not discriminate between the perceived rich tenants out there, the ones with the asset base which are able to continue paying rent, and those whose cash flow simply means that they are unable to do so.</p>
Graham Rounce	<p>Thank you very much both – that's very interesting – it looks like we are expecting these measures to continue as David said, into the start of next year. Linked into that, John, do you think more measures are likely, and do we need a mandatory code?</p>
John Nevin	<p>I think that I agree with David that I think that possibly an extension of the measures may well be called for, so I can see the government potentially extending the measures in time but not necessarily in scope, so I don't see deeper or more stringent measures being brought in but I could certainly see, as David has suggested, that the measures may well be extended.</p> <p>As far as the mandatory code where we have seen Australia go down that route, I mean I don't necessarily see that being called for. I think the real estate market largely balances itself through market forces. I mean in my time in practice, we've seen a huge shift between the bargaining power between landlords and tenants much more in favour of tenants now, and I think the pandemic will see that shift even further, so I as far as a personal view is concerned, I don't see any further state intervention.</p>

David Kozack	<p>And that's an interesting one, I think one thing I would say is, I think the BRC feels that probably the mandatory code is probably not likely, but it does see that government support for commercial rent maybe necessary. In fact the way it sees it is that we need to deal with the mountain of arrears that have built up during lockdown and quite frankly unlikely to be paid back. As far as the retail is concerned, turnovers is lost permanently, it can't be borrowed back to repay a loan or to conger up deferred rent and if I may I would like to share some views UK active, UK hospitality, revo, the BPF and also the BRC have made a joint call for the introduction of a property bounce back grant. The grant is estimated to cost around £1.75 billion, yet it would save 375,000 jobs and it would generate savings to the government of almost £7 billion in the first year alone. Now the way that this would work is that government would make grants of up to 50% of rent and service charges which were demanded but unpaid between March and September. However, those grants would be conditional on an agreement between the landlord and the tenant to account for the remaining 50% and they would do that by following the Governments code of practice. And so eligibility for the grant would really be just for those businesses in sectors that have been disproportionately hit by the crisis and have already seen increasing rates of administration and redundancies and those businesses that are in hospitality, leisure and retail, so it wouldn't be for everyone. As John said market forces will at some stage correct it, but certainly for those businesses that do need that extra level of help and if this property bounce back grant we think is the way forward.</p>
Graham Rounce	<p>Thank you David that's really interesting. Perhaps looking forward a little bit more, how do you see the future for retail and what do you think needs to change as we come out of lockdown and hopefully find a solution to the pandemic in by way of a vaccine?</p>
David Kozack	<p>It's a very good question. It's no secret that parts of retail were struggling before Covid-19, and Covid-19 has effectively just pressed the pause button, but those struggles will continue unless we see some new grants reform. Let's try to give you some examples. Business rates, it's a tax which isn't quite working as it should both in terms of quantum and process and that's hurting retailers. Now as a replacement it's been talked about an online tax but the BRC is not an advocate of an online tax and it just hits retail disproportionately hard and as I said before online has been a lifeline.</p> <p>We need to see downwards as well as upwards in reviews in order to avoid large gaps in the high street, and the adversarial nature of lease negotiation, this master servant relationship is no longer fit for the 21st century, and I was pleased that you in the previous podcast discussed that you've been seeing changes in behaviours and that was incredibly heartening. And this is important because we as solicitors need to be agents of change. We need to make sure that when we see progressive heads of terms we don't through our negotiations introduce fetters on the tenant, make mobility to trade from the premises and alter the premises harder in the name of creating an 'institutionally acceptable lease'.</p>

<p>Graham Rounce</p>	<p>Thank you David. Clearly the landlord and tenant relationship is changing and it seems like this is going to accelerate that process.</p> <p>John another aspect of this is the planning system. How important do you think the government's promised overhaul of the planning system is likely to be?</p>
<p>John Nevin</p>	<p>I think Graham, if the government proceeds with the ideas outlined in the White Paper that they've recently published, we will see some very far reaching changes to the planning system. The idea behind these changes is really to speed up planning and to make effectively to reduce the control that local authorities currently have over decisions, and to effectively ensure more development takes place. So what they are doing is replacing a rules based zoning system is going to be put in place to replace council decision making and council controls so the idea is you allow, you will outline on digital maps areas that will be designated for growth so their outline permissions will be automatically granted for large developments, you will have areas designated for renewal where there will be statutory presumption that permission should be granted, and there will be areas designated as protected where full applications as we know them today will be required.</p> <p>So we will see a smaller number of application documents, we will see shorter fixed timescales for councils to decide planning applications, the idea there is that will be within 8 or 13 weeks, and there is also a proposal to have an infrastructure levy replace the current seal and section 106's and that will be a flat rate levy charged at occupation of the development. So I think the idea is you know, you will see more development, you will see speedier planning decisions and you know much to the dismay of local authorities, you will see control and powers taken away from local planning authorities.</p>
<p>Graham Rounce</p>	<p>Thank you so hopefully combined with a better relationship between landlords and tenants, the planning reform will allow greater flexibility which is something that as this current situation is proven as necessary.</p> <p>David, if I may, just turning to you with your Ocado hat on, how has consumer behaviour changed in the grocery sector?</p>
<p>David Kozack</p>	<p>It's changed in a few ways Graham, firstly bigger baskets. In the earlier days of lockdown it really cantered ambient products, who could forget the rush to purchase toilet tissue but soon that just became larger grocery orders. Now you may think that this is because people are staying in more and of course that is part of it, but I have actually heard otherwise and I heard wonderful stories of people buying multiple units of an item where one is for them and one was for their neighbour, and that communal spirit between customers is simply wonderful.</p> <p>In other changes we've seen more forward buying, customers are now looking to get their delivery booked earlier and further in advance and not always for the same day of the week. Now given that this is something that you John and my team worked on, it would be entirely remiss of me not to mention that moving away from Waitrose and from 1st of September customers will be able to shop for around 5000 M&S products</p>

	<p>instead. And you and I have talked about this before and I think the customers will be very, very impressed with the new Ocado offering and I don't know if either of you saw this but M&S summed this up beautifully and I hope I get this right, I just don't have the right voice for it, it said "this is not just any partnership, this is M&S food meets Ocado". I just thought that was beautifully put.</p>
Graham Rounce	<p>Thank you for that, that's all good to hear. We have already talked about the difficulties, the well-known difficulties that the high street is struggling and was struggling indeed before lockdown and just recently there doesn't seem to be a week that doesn't go by without further announcements. Recent announcements WH Smiths, Tui, DW Sports and the restaurant chain Pizza Express. Where do you think the balance between stores and online shopping will finally settle post-Covid?</p>
David Kozack	<p>Well let me firstly say that that news is disheartening, but I genuinely believe that retail will always be the core part of the high street, but in a post-Covid 19 world it's likely to be supplemented rather than supplanted by pleasure, housing, public services and other uses. From Ocado's perspective we think 5 years of growth in just a few weeks and we believe once you've done your fifth shop, grocery shop and actually less now actually, you're a convert to online grocery shopping. So in terms of the balance that would depend on how you use retail. But it's fairly certain that the new normal will see online shopping as a regular and mainstream part of your weekly shopping habits.</p>
Graham Rounce	<p>John, taking that into account and the transition to online and the fact that that it, as David has said as we all now has become such an established part of consumer activity. Can you identify some the key legal and practical issues that need to be considered?</p>
John Nevin	<p>Yes Graham, I mean I think what we are going to see is the existing retailers who have large real estate portfolios, we are going to see that generate some very interesting ideas going forward about what those property owners do with these properties. And I think John Lewis are an example of that, they've been in the press recently and they have generated some very interesting ideas about how they might explore their wider store estate if indeed the, the plan is to reduce the size of the retail element of that estate. So I think we are going to see the speed of innovation in retail and the conversion of these properties to other uses, really develop over the next sort of 5 years or so.</p> <p>I mean in terms of legal issues what I think we are going to see with retailers is we are going to have you know, the new norm will be a retailer that inevitably has an online presence and I think will also have some form of physical presence and so coming out of the pandemic we will see a lot of retailers and indeed landlords talk about a move towards turnover rents. And that would generate some interesting legal issues in that you know, how do you write that down because you have click and collect you have stores that are sending out their goods from their stores rather than from a warehouse and so in defining and accurately recording those turnover rents that will pose both practical and legal difficulties.</p>

	<p>I think we are going to see more pop ups, we're going to see more, in America we've seen Amazon opening stores where you know people use a mobile phone that records their entry and they walk out with their goods and there's no interaction with a till as we would normally recognise it or indeed with any staff and so there is going to be huge innovation on the high street, and I think as lawyers we are, we are going to have to try and keep up with that in terms of how that is documented, in terms of that occupation and the charge, the charges to that occupation of that real estate going forward.</p>
Graham Rounce	<p>Thank you John, I think we can pick up a theme there that flexibility not just in the retail sector and particularly linked into what we were talking about by the reform of the planning and the relationship between landlords and tenants and clearly how people use space needs to be dealt with on a more flexible basis.</p> <p>Turning back John if I may to the logistics sector, generally that is a sector that is perceived to have been held up well while others have struggled across the board. Are we seeing significant interest in investors?</p>
John Nevin	<p>Yes we are, I mean I obviously, David and I work together as Ocado are expanding their estate of customer fulfilment centres, I work with their data centre clients and you know there is one key theme that we are seeing that the demand for space is very hot at the moment. And you can't just put these facilities anywhere there are, as David can probably comment better than me that there are geographical facts in terms of where you want to be, which is obviously the biggest decision but then there's a whole host of micro-factors in that, you know, is there, is there sufficient power nearby, where is the substation, how is the road network interact with where you want to be, what is the position on utilities, what is the connectivity and so getting, getting your logistics estate in the place where you want it, and with the necessary facilities is very difficult and it's driving, driving prices in that sector and there is a lot of demand, a lot of bidders out there all competing for the same space.</p> <p>I mean one of the fascinating things I find and Ocado is an excellent example of this is when you actually look at the warehouse itself it sought of turns landlord/ tenant relationship on its head slightly because the landlord is really, you know effectively often developing the skin of the property, the outer shell and the roof and that's not where the value is, you know as David will no doubt tell you, the typical Ocado warehouse, the value is in the kit that's inside, you know the value of that kit inside the warehouse dwarfs the value of the warehouse itself and so you know that's the fascinating thing about the logistics centre going forward, they really are, you know houses of huge technology.</p>
Graham Rounce	<p>Well thank you very much, we are drawing to the end of this podcast so can I ask you both, do you have one key takeaway?</p>
David Kozack	<p>Yes, if I can step in first but firstly thank you both again very, very much indeed. My key takeaway would be as follows, in order to give the retail sector the best opportunity to trade its way out of the very difficult conditions in which it finds itself, landlords and tenants will need to start to cooperate far more than they have</p>

	<p>historically, John was already talking about that and generally we are talking about how we deal with our landlords. The government wants us to consider the national interest and that means reaching agreements on rent and agreeing leases that don't act as a fetter on a tenant's ability to be agile and trade in a frictionless way as possible. If we fail to do this, the government and this government in particular will not be shy to legislate as it has made no secret of how far it will go to get us out of this pandemic and through Brexit. Now you may think this a very bold statement but please bear in mind the government already have a track record of intervening when it believes the market is not acting in national interest. Just look at the power that it's given to the telecommunications operators.</p>
John Nevin	<p>I mean I, I think that's a good point David and Graham my takeaway I think is twofold, which is you know as far as I have seen in my career and I think even more so as we come out of the pandemic, the real estate industry reacts to consumer behaviour and so it will be consumer behaviour that ultimately determines what happens to our high streets and what happens to our local communities as this division between online retail and physical retail you know, takes hold.</p> <p>I mean, my other sort of connected point on that is I think that it really in the interests of local authorities to take perhaps more ownership of, of their local high streets, of their local communities so that they can curate in the way that you've seen the landed estates like Portman, what they have done around Marylebone, you know how they are able to take a much more longer term view and not solely be driven by the profit motive. I think, you know, it, we are reaching a point where local authorities potentially need to step in to rescue the, the inner parts of their local communities to ensure that some form of retail offering survives in a physical form and that helps in both the communities and ensure that, you know, we have places to live, where all consumers are served.</p>
Graham Rounce	<p>Well thank you both, and particular thanks to David for joining us and many thanks to all of you for listening. If you have any questions then please get in touch with your usual Slaughter and May contact.</p>

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