KINETIC CONSULTANCY

EXPERT SURVEY REPORT:

SHAPING HIGH-TRAFFIC COMMERCIAL CONTRACT STRATEGIES IN A FAST-CHANGING WORLD

SEPTEMBER 2021

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INTRODUCTION: SENSE OF URGENCY DRIVES COMMERCIAL CONTRACT AGENDA

Covid-19 has brought with it an unprecedented range of challenges for high-traffic locations, with the example of those involving retail immediately springing to mind. Innovations in many areas of retail operations such as digitalization and fulfilment for example have been introduced at an extraordinary rate, in the process introducing advances and efficiencies which otherwise could have taken years to be thought of and implemented.

That was simply because there was previously no great urgency to make fast, future-thinking changes, and thus the evolution of business models was slow across large swathes of the high-traffic retail industry.

There is nothing like a deep crisis to put an end to any level of complacency in commercial partnerships and the make-up of related contracts, which are at the core of high-performing, high-traffic industries. A sense of urgency has been created to effect the changes needed to their structure to ensure future competitiveness for both landlord and retailer (or other types of high-traffic partner), and we have set out with our report to highlight what the nature of these changes needs to be.

Often over time a 'laissez faire' partnership develops between commercial parties, built on trust in each other's will to contribute their best efforts to collective success. At an airport for instance, you'll find a vast web of close-knit partnership relations. However, that collective success in the past decade has been fueled by passenger growth, economic growth or the global trend of urbanization.

Unfortunately, with pre-pandemic 2019-like air traffic numbers estimated to return around 2024 there still is a long gap to the bridge[1]. That applies not only for airports but also to other high-traffic locations like high street and shopping malls.

> "
>
> Without a sense of urgency, desire loses its value.
>
> **JIM ROHN**

There is always the serious chance in a partnership that appears on the surface to be functioning well, that the partnership and its value will dilute and receive less "investment".

Commitments between parties are contractually long-term and complacency slowly creeps in. We call it “the silent partnership killer”, as it eats away at the overall level of performance. Current market circumstances fueled or accelerated by the current pandemic create an incentive to stamp out that attitude and drive the sense of urgency.

Commercial contracts will certainly shape the future of many high-traffic locations. How much, and in what direction that will bring the high-traffic industry, is the central topic of this report.

With overlapping business dynamics and environments where certain trends have a different level of maturity, we have consulted industry experts from the field working in:

- Airports
- Meeting & conference centers (MICE)
- Rail and public transport
- Shopping centers and real estate
- Architect designers, consultants, and scholars

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WILL COMMERCIAL CONTRACTS SHAPE THE FUTURE OF HIGH-TRAFFIC LOCATIONS?

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Every partnership is formalized in a contract which sets out the details and parameters of that partnership. Now partnerships have been under pressure, the contract, which is also the legal foundation of the partnership, has been brought out of the filing cabinet more than ever before.

We haven't come across a commercial director who hasn't spent the last year discussing the commercial contracts in their portfolio, or any retail operator which has not been doing the same with the landlord.

CASE STUDY

Incheon International Airport, Seoul, South Korea

The Covid-affected collapse of international passenger traffic has thwarted the process of awarding the remaining licenses in Incheon International Airport Corporation's Terminal 1 tender, which first launched in January 2020.

Three bidding rounds have been and gone since the January RFP, which concerned eight airside packages over an initial 8,628sq m of retail space. Several concessions were left undecided after bidders stepped away from the contracts on offer[2].

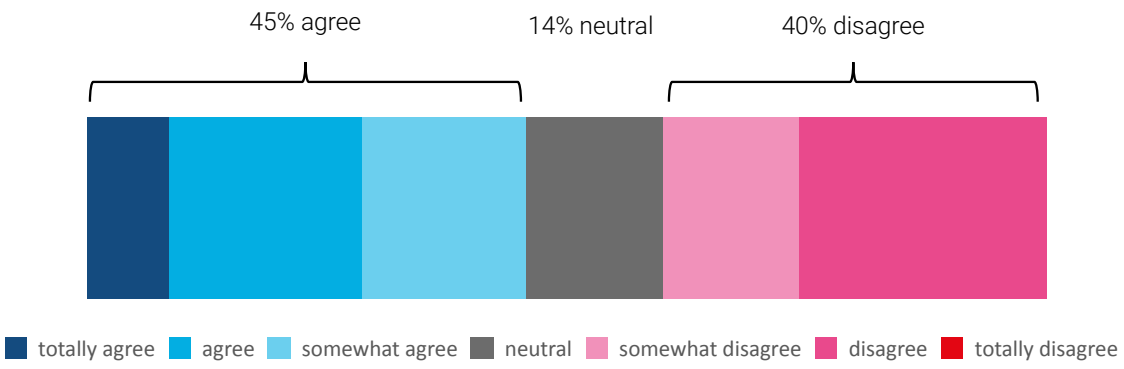
"We have been seriously evaluating how to evolve the business model from revenue-centered to partnership-centered, as we learned a lesson from this pandemic era that intangible values like partnership, sharing and mutual growth, matter."
Bumho Kim, Deputy Executive Director Incheon International Airport Corporation[7]

The shape and content of a commercial contract is important because it impacts the commercial revenue which itself forms an essential part in the viability and prosperity of high-traffic locations. The role commercial income plays in the business model and business dynamic is different for each type of high-traffic location but ranges from "everything to very important".

The future success of commercial revenues determines the result of companies active in the high-traffic industry, their ability to invest, innovate and therefore shape their future.

In response, industry experts are undecided if changes in commercial contract structures will be the number one driver for change. The survey showed over 45% of experts agree to the statement that "The biggest impact in commercial revenue for high-traffic locations will be driven by its commercial contracts".

Figure 1 : Survey respondent reactions to the statement: "The biggest impact in commercial revenue for high-traffic locations will be driven by its commercial contracts"



Source: Kinetic Consultancy Flash Survey: Commercial Contracts

CASE STUDY

Simon Property Group

US-based Simon Property Group, the largest owner of shopping malls in the global market, has reported that sales at all properties reached pre-crisis levels for the first time in June this year during the last fiscal period under review.

Simon Property reported an 80% increase in mall and outlet sales compared to June 2020. In some States, sales have already surpassed pre-pandemic 2019 levels.

The company expects that the market recovery will spur retailers to enter new leases. Last year, a significant amount of retail space in US malls emptied due to bankruptcies and retailer business optimization programs.

"We continue to see demand for space across our portfolio, from local, regional and national tenants, entrepreneurs, restaurateurs, and mixed-use tenants...it's growing day by day."

David Simon - CEO Simon Property Group[8]

There are strong differences in the high-traffic retail market, both by type and by location. Retail parks and outlet shopping in general have shown strong performance. High street shopping, airports and many other types of locations have had to adapt to harsh realities brought forward by the COVID-19 crisis. Vacancies have been increasing and in the airport sector sales expressed in sales per passenger have been declining for many developed airports in the past decade. The pandemic has simply exacerbated this.

Given the level of urgency, uncertainty, and the impact on business from the pandemic, now is the time to deviate from business as usual and innovate the business model, innovate the partnerships, and design a new format for all commercial contracts.

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COMMERCIAL CONTRACTS OF THE FUTURE

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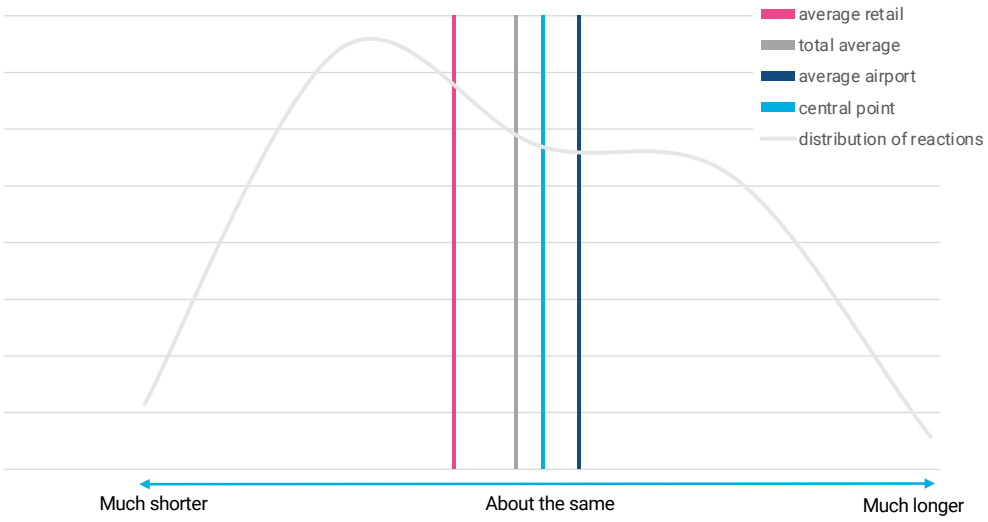
Commercial real estate contract length has been decreasing over the past decade typically from up to a 9-year average to a 7-year, sometimes 5-year average, depending on the market segment and category. But will this trend continue when we return to normal footfall in the high-traffic sector?

We have seen short term renewals and extensions to leases to cover the extra costs of dealing with the pandemic and/or to bridge a gap of uncertainty, but we also hear the call for more short term contracts to be more flexible in uncertain times.

The survey results show a slight but significant difference between airport professionals and other retail professionals.

Figure 2: Survey respondent perspectives on future contract length



Source: Kinetic Consultancy Flash Survey: Commercial Contracts

Overall, more respondents think contract length will be shorter. However, if we look within segment averages, differences show in perspectives on this length between airport professionals and retail/shopping center professionals.

We see that retail professionals believe that the trend will continue and will result in a somewhat shorter contract length. Spurred by an ongoing pop-up trend that was fueled by the pandemic, retailers already sign more short term contracts.

Unibail-Rodamco-Westfield reports in H1-2021 earnings:

Pragmatic approach to lease terms to navigate short term challenges and protect long term value, with 56% of H1-2021 deals being leases between 12 and 36 months.[3]

Airport professionals are slightly more towards the other side of the equation and more often think that contract length from now on will increase again. When looking into the open-ended section of the question, in which usefully a lot of respondents explained their choice, there seem to be **two driving forces: Investment responsibilities and contract flexibility**.

INVESTMENT RESPONSIBILITIES

For many European countries some form of temporary financial support was regulated. We saw this in Germany, which announced a €600 million package of financial support for its biggest airports. Meanwhile, property taxes got suspended in France and in the UK a moratorium was issued on commercial lease evictions.

In a number of instances, Covid forced real estate owners and operators to be more flexible in write-offs and in payments.

These actions were necessary but also resulted in a higher debt and an uncertainty leading to a longer duration required to earn back lost income and pay those debts, which in turn will require longer contracts. As one respondent puts it:

> Potentially lower returns as passenger numbers build back, will mean longer contracts to recover investment.
>
> **(AIRPORT PROFESSIONAL, EUROPE)**

What will be the long-term effect for the industry with longer write-offs and contract duration?

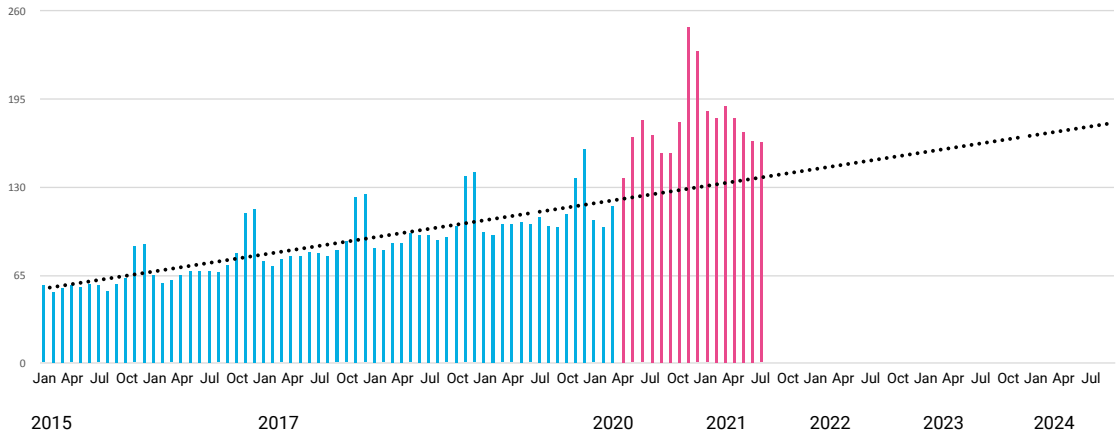
Revenue growth for many high-traffic locations has been dependent on visitor/passenger growth. Revenue per passenger for most airports is under pressure. There seems to be a difficulty monetizing the once unique retail offer of combining big brands and a large audience, towards a customer base that has all the products one click away at home and on the go.

The demise of this retail revenue is offset only partially by an increase in customer spending on direct consumable goods such as, for example, coffee, lunch or snacks on the go.

When looking at contract length from a financial perspective it is logical to think that when the debt increases and the ability to pay back each month does not, that total length needs to increase. But this could also be seen as doubling down on a broken business model and raises a series of questions.

For airports, with a return to pre-Covid numbers projected to return around 2024, how long will the commercial contracts need to be?

Figure 3: Covid-19 spiked internet sales



Source: Retail Sales Index internet sales, 2018 =100, ONS-UK 2021

Retailers on the other hand, have seen a quick turnaround once restrictions were lifted in several countries. Their customer base, however, got more acquainted with e-commerce which has effectively pushed the timeline for the rise of e-commerce a few years forward.

What will this mean for new investments in innovation and increased customer experience?

Will the industry ever be able to pay back the debt of a lost year and a half, whilst also catching up to the new retail environment with which it was already struggling?

Recovery reasoning should not only be deficit-based – what could be gained in these times and which assets could be used to turn this debt around?

CONTRACT FLEXIBILITY

An important element of any contract is to mitigate the risk of doing business, having access to an audience or being sure of collecting rent (return) for your investment. But slowly commercial contracts are moving away from just the transactional towards a more purposefully 'experience design' perspective, including responsibilities outside of the primary basic transactional agreement. Or as one respondent aptly put it:

> Shorter duration of contract will be driven by an update of experience and design to the trends and consumer needs.
>
> **(ARCHITECT/DESIGNER, ASIA)**

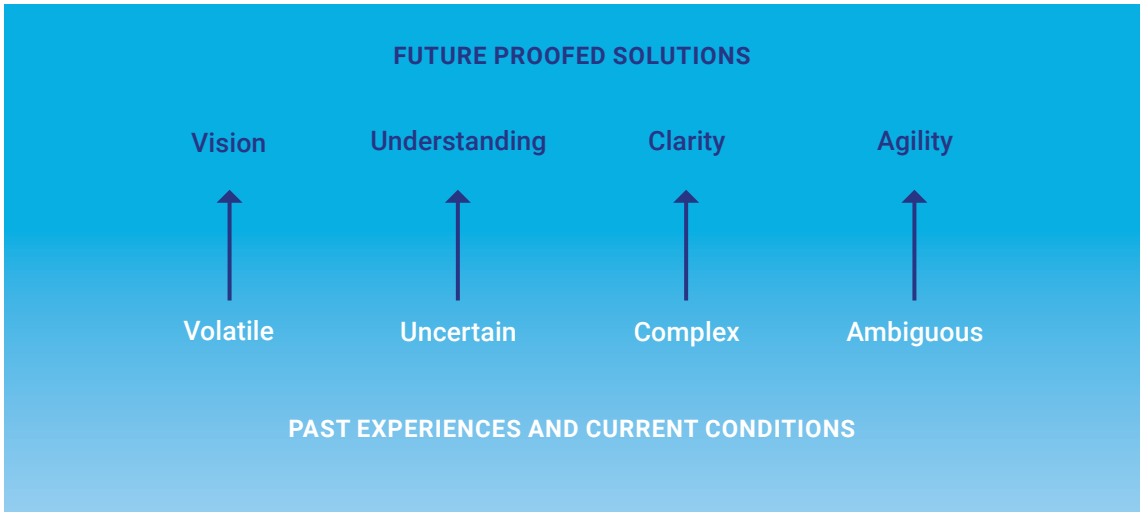
This could result in shorter contract terms but might also be regulated by the flexibility of certain parts of the contract.

> Flexibility will have a much higher priority in commercial contracts. Retail centers will engage in short(er) term contracts and pay-as-you-go options.
>
> **(SHOPPING CENTER EXPERT, EUROPE)**

Will flexibility allow for a coherent customer experience?

The future is not what it used to be. We can no longer rely on the comforting assumption that the future will be a continuation of the past. The current situation in the high-traffic industry allows no more room for complacency. Many variables are uncertain, complex, sometimes ambiguous, or simply not yet known.

The current turbulence we are in fits with the dynamic which is known as a 'VUCA World': **V**olatile, **U**ncertain, **C**omplex, **A**mbiguous.



With more flexibility, a retail environment should be better positioned to adapt to the VUCA world we live in. But for a lot of high-traffic locations this will demand a more hands-on management of the retail spaces by responsible landlords. More flexible partnerships are needed, guided by a clear vision and commitment to a greater transparency between landlord and commercial partner. Without the clear vision, short term flexible contracts can make a mess of a retail environment leaving retailers in the dark on their future competitiveness and possible earnings. Without the transparency between the partners, it is difficult to keep trusting each other on the potentially rocky road towards that vision. It remains to be seen if shorter and more flexible contracts can provide room for innovation in the omnichannel shopping experience. However, this begs the question – if an omnichannel experience is sustainable with ever changing partners?

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PARTNERSHIP BETWEEN LANDLORD AND RETAILER

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The perspectives of longer vs shorter contract duration cancel each other out in the total average arising from the expert responses to our survey (see figure 2), nicely illustrated by this quote:

> The duration as such will not change that much, however I do believe that future contracts will have more escape/termination clauses to deal with unforeseen issues like a pandemic.
>
> **(SHOPPING CENTER EXPERT, EUROPE)**

But it is not impossible that within a VUCA world that the following two perspectives on contract duration will be able to coexist.

Longer contracts in the form of partnerships between lessees and lessors focused on the overall retail space vision, paired with shorter, more flexible and more actively managed contracts for smaller parts of the entire space.

When asked about the one most prominent shift in contracts, the two most selected options were:

- **The increasing use of a more flexible rent base (39%)**
  The difficult challenges that Minimum Annual Guarantee (MAG) rental creates, particularly for the tenant, have been laid bare and much discussed since the COVID-19 pandemic struck. Against this backdrop, many of our expert panelists think that a more flexible rent base in commercial contracts (for instance tied to passenger numbers in airports) will become more prevalent.

  But who is responsible for the footfall at high-traffic locations? And if a big portion of your rent is dependent on a retailer's turnover, are you able to influence passers by to convert into shoppers?

  Take personnel costs, more staff means potentially more revenue, but not necessarily more profit. These dynamics fuel a stronger connection between the responsibilities of the lessee and the lessor. This hints at the most selected option, as follows…

- **The increasing number of partnerships through, for instance, joint ventures (42%)**
  The number of joint ventures in high-traffic locations are hard to measure but they do exist across a diversity of aspects. The construct of a joint venture can be the vehicle in which the strengths of both partners are combined.

  It also serves as a vehicle to share risk and reward. The joint venture could even move outside of the original location and be effective in other high-traffic environments.

CASE STUDY

Amsterdam Airport Schiphol and Gebr. Heinemann

In 2015 Schiphol Group sold a 60% stake in its travel retail arm, Schiphol Airport Retail, to Gebr. Heinemann. The companies have established a joint venture to operate the airside liquor, tobacco, and confectionery business at Amsterdam Airport Schiphol.

Schiphol Group retains 40% of the shares and the joint venture has continued to operate under the name of Schiphol Airport Retail (SAR).

The companies said: *"With Gebr. Heinemann as a jointventure partner, the position of SAR will be reinforced with knowledge and experience in travel retail, e-commerce and logistics topped with clear end-consumer focus and expertise. SAR will be certain to respond well to rapid future developments in the international travel retail market and changes in needs and demands of travelers."*[4]

Delhi Duty Free Services

Founded in 2010, Delhi Duty Free Services is a joint venture company between DIAL (Delhi International Airport Limited), Yalorvin Limited (a subsidiary of Aer Rianta International) and GMR Airports Limited.5 The business grew from virtually nothing to one with annual sales greater than US$150m.

All three parties involved have benefited from this in that they have seen their profits grow. Furthermore, GMR has developed in-house knowledge on how to operate a successful duty free business, which it has utilized in other airports under its control.

The fact that only 9% of respondents (of which almost none work in airports) believe that new added services will be the biggest shift in future partnerships shows that the focus is on the current set of business models (especially in airports). This is interesting considering the pressure on the current business model and the direct value-added service it could bring to both the retailer as well as the airport operator. Data fuels shopper journey relevance, which is key for retaining customers. Personalization is a key element here: 26% of shoppers will pay more for personalized recommendations[6].

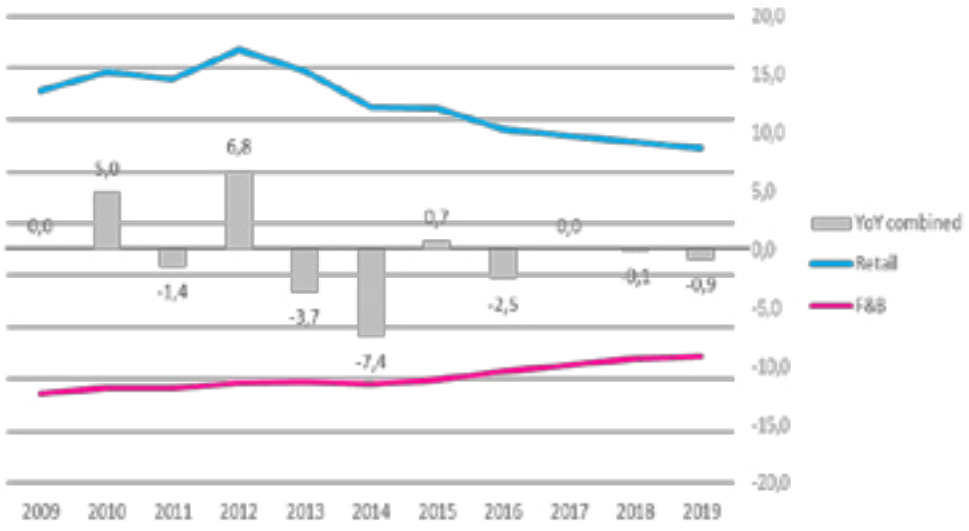
The current decline in retail revenue is clearly a tough nut to crack. High street has shifted a lot of its retail spaces into direct consumable stores and adding services such as co-working

offices, housing and leisure. Even other sectors of retail are adding and blending retail, leisure and food & beverage within shops. For airports this shift is a bit more difficult due to existing layouts of the floorplans or because of exclusive partnerships.

But airports believing passenger retail spending is just shifting to food & beverage, and that change is not that necessary, are taking the easy way out in our opinion. Looking at food & beverage spending in Europe across the five years pre-Covid, out-of-home food & beverage consumption has grown 3% year-on-year.

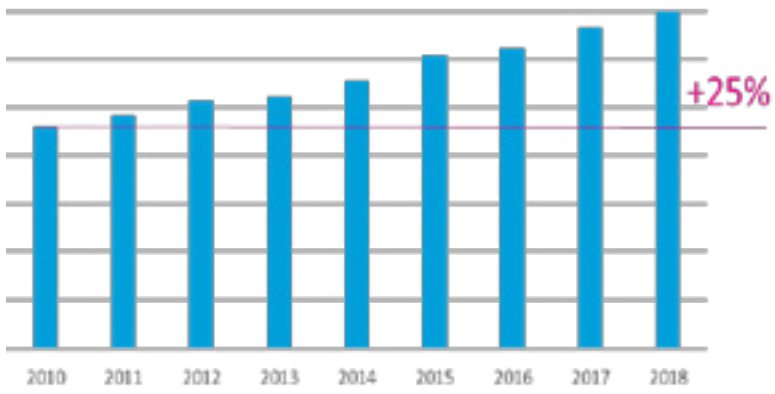
This means that the growth in food & beverage spending at European airports, for example, is following the market at best. The fact is that for airports that do have a rising spend per passenger it is often mostly attributable to infrastructure catching up with passenger growth. For instance airports opening their new airport lounge to cope with increasing passenger numbers.

Figure 5: Retail and F&B Spend (€) per departing passenger Amsterdam Airport



Source: data from public listings of Schiphol Group

Figure 6: Total out of home food consumption EU-28



Source: Eurostat, 2020

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DATA/DATA-SHARING AS A VALUE DRIVER IN COMMERCIAL CONTRACTS

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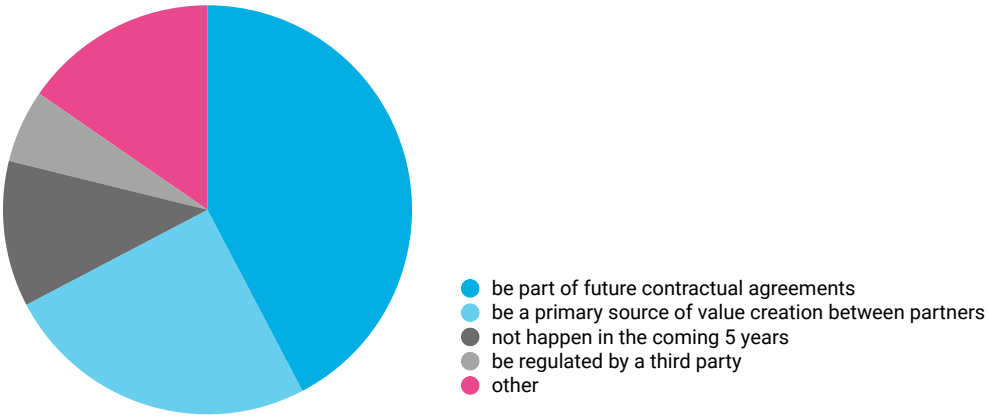
The convergence of digital and physical retail could also be a driver for new services. Think of a 3d body scan service making sure your online clothing shopping will always be a perfect fit, or a personalized menu tailored to your nutritional needs. But not only for visitors can the convergence of physical and digital be a benefit. A lessor can help to expand a lessees presence at the location through smart signage or help save valuable shopping space by providing flexible on-site storage and delivery. Possibly resulting in a much more diverse set of business models in a commercial contract. As stated before 'added services' is seen by only 9% of respondents as the most prominent shifts in commercial contracts. But as the following figure shows it will be part of future contracts.

> Physical and digital retail will continue to converge which should be considered in real estate contracts.
>
> **(AIRPORT PROFESSIONAL, EUROPE)**

For new or renewed partnerships based on a variable rent or a joint venture, some sharing of financial details between landlord and tenant will increase the transparency between both parties. When asked about this continuous sharing of data between parties, respondents think that this will be the norm for future contracts and could be a primary source of revenue.

But only a small proportion of respondents think that a third party will be overseeing this potential transaction. As mentioned by a few respondents in the open-ended section relating to our data question, some of the partnerships are already sharing data at airports, for instance.

Figure 7: Data sharing with commercial partners



Respondents from the 'other' category in the pie chart above also expressed their reservations about the value of data sharing in the near future. Some data is already shared but there is almost never a direct business model attached to it. And there are some reservations on whether data sharing will be done at all. Regulation will become more prominent, and privacy more actively protected.

> Commercial contracts will get more complex covering all kinds of different scenarios. This is driven by the increased desire for more control from the landlord over the retail concepts. Most likely the opposite will happen, meaning that we will move from a partnership approach between retailer and landlord towards a cold, pure data driven agreement.
>
> **(AIRPORT PROFESSIONAL, EUROPE)**

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WHAT'S NEXT?

WHAT'S NEXT?

Whatever you as a high-traffic professional chooses to do with regards to commercial contracts, most likely it will impact the shape of the high-traffic location that you operate in. Contracts can last for several years and even decades. The direction and focus of your commercial contract will be part of the location's DNA.

We have discussed some preliminary outcomes of this report with several experts using more in-depth interviews, to extract a deeper understanding of their perspectives. All of these perspectives point to some extent towards "the elephant in the room," the omnichannel experience of people in high-traffic locations.

> To grow, they need to break out of a vicious cycle of competitive benchmarking and imitation. Because those who keep comparing themselves with others will tend to become even more comparable.
>
> **W. CHAN KIM AND RENEE MAUBORGNE – AUTHORS BLUE OCEAN STRATEGY**

Whether shopping in the mall for fun, buying online, or being inspired by a brand experience at an airport and enrolling in a subscription model afterwards (for example with a razor blade brand), these are all increasingly common, complex, and often not directly attributable to the high-traffic location or experience.

The contractual model which hasn't strongly evolved over recent decades seems to be ready for a revision. Perhaps new models would have allowed retail giants of our industry such as Dixons and Massimo Dutti to remain prominent in airport retail, for example. Replacing them with more F&B will only go so far as well.

In a quest to thrive or survive, the high-traffic industry typically turns to benchmarking. Benchmarking can be a valuable tool but, by definition, it looks at historical performance. Insights into the future, and the industry's tools and targets require a different approach.

Netflix isn't looking at Disney+ or Hulu for what to do next in the delivery of its streaming service. The biggest competition of Netflix is gaming, which leads the company to comparing itself with the communities of Roblox and Epic.

The same is true for online retail. As key competitors of high-traffic locations, they aren't copying high-traffic retailers, they create a vision of their own and work to generate new value with every update.

Optimizing the current and planning for the future can be decided in parallel. But the format of the commercial contract needs the possibility to support new roads and solutions.

Who are the most likely companies from which you can learn? How are you extending your field of vision beyond the direct competition in your field?

Benchmarking's greatest use is as a tool to see where you can improve, not where you fit in.

ACKNOWLEDGEMENTS

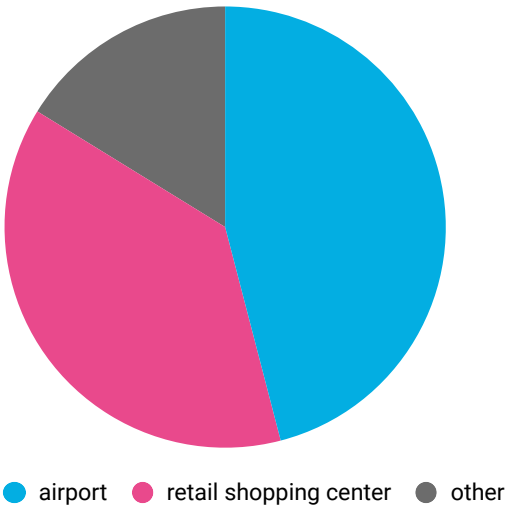
First and foremost, we would like to thank all the experts who have taken the time and effort to fill out our questionnaire. By supplying us with your insights you are also helping shape future high-traffic commercial contract strategies. That is of great value to anyone involved in our high-traffic industry.

This report sprung from conversations which we held with several industry leaders. In those conversations we learned that there was – and still is – a need for insights on what commercial partnerships will build upon in the future.

The need for these insights is driven by the speed of changes our market has been seeing – speed accelerated by the COVID-19 pandemic. With this report we hope to get some movement in a shift towards a more innovative retail landscape in the high-traffic industry.

Participants in our survey are primarily involved in the high-traffic industry in Europe, which to some extent limits the answers' perspective to the European context. Furthermore, almost half of our respondents have a connection to the airport industry, and the other main group is shopping center related. High-traffic locations perspectives such as rail, are therefore less included.

Figure 8: Background of respondents



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5 Source: https://delhidutyfree.co.in/about-us
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8 Source: Mall.com (https://www.malls.com/news/news/revenues-of-shopping-malls-and-outlets-reached-pre-crisis-levels-for-the-first-time.shtml)

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