Retail Renaissance 2025

Lesson #6: Show me the income

Knight Frank

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The last of six papers exploring what other real estate sectors can learn from Retail's fall and unlikely rise again

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Lesson #6: Show me the income

Income return – undervalued but should not be underrated.

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3 KEY LESSONS:

- Never undervalue the importance of income return – a stable source of revenue whatever the tempest.
- Income must be protected and not taken for granted – it is guaranteed, but only under certain conditions.
- Income is not immune to structural change – to protect it, a landlord must be cognisant of wider market forces and act accordingly.

Rental growth. Capital value growth. High total return. Yield compression. Unquestionably these are top of virtually any landlord's or investor's wish list. Income return? Something of an afterthought, a distant relation to the other metrics – but by no means a poor one.

INCOME – PAWN OR KING?

There is actually a school of thought that income is actually king and that income return trumps everything else. Some investors and REITS (e.g. LondonMetric) make no bones about this and this is a central plank to their investment strategy. And amidst all the current (and I'm sorry to say, future) global geo-political upheaval and economic fragility, the income-trumpeting school of thought is likely to recruit many more members and converts going forward.

The case for prioritising income may seem radical compared to the aforementioned other property performance metrics. But it is actually the most fundamental thing of all, the very premise of making money out of property. A landlord owns a building, they let it to a tenant who pays them a rent. The longer the agreement, the more fixed and stable that source of income is. Simple beyond belief.

RETAIL AND INCOME – SURPRISING BEDFELLOWS?

Income has historically always been one of the retail market's strong suits. Back in the day, retail had many strings to its investment bow, in many cases, all the wish list elements outlined at the start of this paper. But obviously, the retail market has been through the mill massively since the late 2000s, through a toxic combination of external forces (GFC and COVID) and deep-seated structural change. Rents and capital values rebased (and some) and yields softened (and some more). But retail income held firm and for a number of years, this was the last string left on the proverbial investment bow for retail.

Why has retail always delivered such solid income returns? This is far easier to answer historically than latterly. Historically, it actually owed more to factors that now appear highly anachronistic – long leases with upwards only rent reviews. Retail leases across all channels (high street, shopping centre, retail warehousing) were typically 25 years, with rents subject to open market review or pegged to RPI/CPI. Either way, they couldn't go down. As long as that tenant didn't go bust, income return was guaranteed.

> "Retail property markets have since changed – whisper it, but arguably for the better."

Retail property markets have since changed – whisper it, but arguably for the better. Lease lengths have come down significantly and there is far greater flexibility than before, and generally everything is much more tenant-friendly. Most shopping centre leases these days are for a maximum of 10 years, and indeed, more likely five, with multiple break clauses written in. Income is less assured and stable than it once was.

Despite this, retail income returns have not collapsed, despite all the trials and tribulations of the market over the last decade / 15 years. For the simple reason that many retail tenants have remained in situ and have continued to pay the rent. Yes, vacancy rates have risen and of course, there has been significant occupier fall-out through so many well-documented retailer CVAs and administrations. But a surprising amount of vacated space has actually been re-absorbed by other tenants and income, one way or another, has been preserved.

Protecting retail income is a far tougher undertaking these days than it was on the easy street of 25 year leases and upward only rent reviews. But that is one of the painful lessons that retail has learnt on its journey towards renaissance. As outlined in other papers in this series, complacency and underinvestment are crimes of lethargy and real estate has to be

Retail income returns – steady and still competitive
Historic income returns by sector (%)

SECTOR	SINCE INCEPTION (1981)	10 YEAR AVERAGE	5 YEAR AVERAGE	2 YEAR AVERAGE	2024
All Offices	5.9	4.1	4.1	4.5	4.7
All Industrial	7.2	4.5	4.1	4.1	4.5
All Retail	**5.7**	**5.2**	**5.5**	**5.7**	**5.8**
Retail Warehouses	6.6	6.1	6.4	6.3	6.3
Shopping Centres	5.9	5.4	6.1	6.6	6.5
Standard Shops	5.3	4.1	4.2	4.3	4.4
Supermarkets	6.3	5.4	5.6	6.3	6.4

Source: MSCI, Knight Frank Insight

constantly on the front foot, evolving with its occupational market. And to be proactive as well as reactive.

There is still something of a hierarchy within the various retail property sub-sectors in terms of income profile, although, numerically at least, the differences are not vast. Over the longest timeframe (since MSCI/IPD inception in 1981), all retail has delivered an average annual income return of 5.7%. Retail warehousing (6.6%) and shopping centres (5.9%) have both exceeded this figure, while high street shops have delivered a marginally lower income return (5.3%).

STABILITY AMIDST A TIDE OF UNCERTAINTY

There has been a slight reversal in recent times and this is forecast to continue over the next five years. Perhaps surprisingly given their greater exposure to ongoing structural change, shopping centres have delivered the strongest annual income returns over the last two years (6.6%), higher than offices (4.5%) and industrial (4.1%), a figure we forecast be maintained over the next five years.

Five year forecast income returns for shopping centres (6.6%) are slightly higher than both retail warehousing (6.4%) and supermarkets (6.2%). However, there are tangible differences between the sub-sectors. Lease lengths in retail warehousing are likely, in general, to be longer than in shopping centres. In supermarkets, a new lease will invariably be longer still, definitely 10+ years, probably 20+. As explored in our *Foodstores: a Feeding Frenzy Report*, the reason for this is very simple: stores are fundamental to all the supermarket operators, they are what they do and they remain committed to ongoing occupation. Not at any cost, but a defensive and offensive position they will fight tooth and nail to maintain.

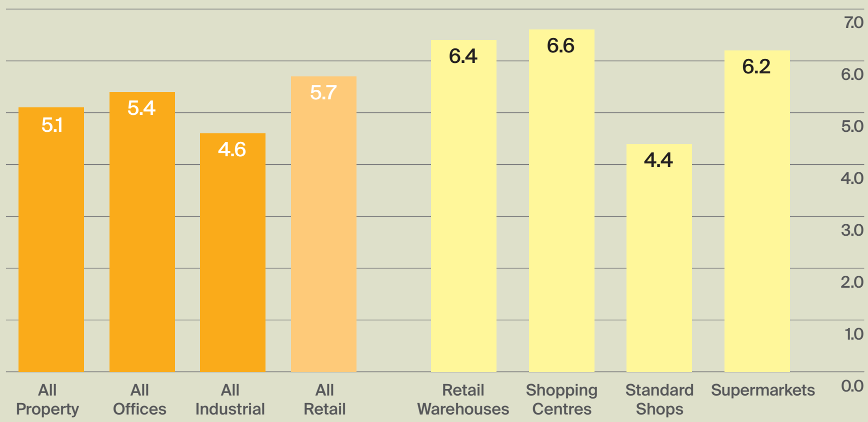
Whilst the forecast figures may be very marginally lower, income for supermarkets and retail warehouses is far lower risk than in other retail channels. Indeed, few, if any, property sectors promise as robust, low-risk, long-term income as supermarkets. There may be some market concerns currently around Morrison's and Asda's covenants – even if founded (which we do not believe them to be), their ongoing status as functioning foodstores is beyond question, even if occupied by a competitor.

STRUCTURAL CHANGE – THE GREAT LEVELLER

The merits of compound income form something of a refrain with LondonMetric's founder and CEO Andrew Jones: *"We are a thematic triple net income investor in structurally supported sectors with high quality assets that enjoy strong occupier contentment. Logistics remains our strongest conviction call for accelerated rental growth, particularly urban logistics, and this weighting is expected to increase materially as we reinvest proceeds from non core and ex-growth asset sales, with approximately £180 million already sold or under offer since year end."*

"Structurally supported sectors" are the operative words here. In the eyes of LondonMetric shopping centres and high street shops fall more into the category of "structurally challenged sectors", hence their non-exposure to them. Retail warehousing and supermarkets are more "structurally supported" and therefore fit their investment criteria, albeit behind logistics in terms of priority. But as explored in **Paper 1** of this series, structural change is a real leveller and can strike any sector in any guise. Above all, this again highlights the need to constantly

Forecast income returns 2024 – 28
% p.a.



Source: REFL, Knight Frank Insight

see the bigger picture, to be aware of potential structural change and to strategise accordingly.

As already flagged, a significant flight to income is likely to be a by-product of the current and future geo-political and economic turmoil. A migration to a modicum of assurance amidst a sea of uncertainty. An average income return rate of 6%+ certainly looks enticing given current 10 year gilt yields of 4.75% (as at 22 May 2025). With heightened volatility across equity markets, UK commercial real estate stands out as a defensive, income-producing asset class – historically viewed as a safe haven for global investors. And retail is able to hold up its hand as proudly as any other use class.

FINAL THOUGHTS

The last of this insight series, the importance of income ties together many of the other insight papers. Strong income returns are by no means a gimme. Any threat of structural change must be first understood, then neutralised at worse and embraced at best. Potential oversupply and obsolescence risks must be proactively addressed and managed. Scale provides some shelter to the storm, but the overriding end game has got to be relevance, whatever that may mean in any given location or context. Maintaining the right level of investment is paramount and there is no room for complacency. Occupier is king and after all, they are the ones providing the income. And happy tenants pay good income.

Retail has been there, seen it, done it. It has been a long, painful journey, but we are someway down the road to salvation. Unfortunately, that road is never-ending, another painful lesson that has had to absorbed along the way. Be that as it may, other property sectors would do well to listen to retail's hard-earned lessons.

Forewarned is forearmed.

THE AGENT VIEW

"Investors going large and long on income"

Dan Serfontein – Partner, Retail Capital Markets

"From an investment perspective, resilient, long income remains the main focus for Core & Core+ investors – increasingly so given the current economic backcloth. Local Authority Pension Funds continue to dominate the core markets, with a propensity to focus on dominant retail parks, often anchored by food or DIY operators, guarantors of strong, stable income.

Whilst a number of retailers' standard position is a 5-year lease term, we have seen a greater increase in key anchor tenants, such as B&Q, offering rarer 15-year unbroken terms. Retailers agreeing to longer rather than shorter terms, who'd have ever thought? But the net result is long-dated secure income from a landlord's anchor tenant. In an environment where the likes of B&Q have seen a number of stores close for redevelopment or acquired by other retailers such as Home Bargains or Lidl (for owner occupation), coupled with a severe lack of suitable alternatives (due to low vacancy rates and limited new stock being developed), these long leases enable tenants to 'protect' their best trading stores. A defensive win for retailers, an income win for landlords.

The flight to long income is perhaps best illustrated by the French SCPI funds, who are currently the most active Core+ buyers in the retail warehouse market. SCPI funds, in a similar way to Realty Income, pay investors a monthly dividend. Therefore, securing long income (whilst offering yield) is an absolutely essential criteria for investing.

So, is retail really returning to the days of "key money" and "insurance leases", once solely the prevail of Bond Street and Oxford Street (trophy locations where retailers simply had to be and were prepared to pay handsomely for the privilege)? In some instances, yes, but clearly not universally so. These core buyers will focus on the best, most secure income opportunities (where we have heard stories of retailers battling it out to be on the best parks).

But opportunities for other, more risk-on investors, do still exist across the retail sub-sectors. Believe it or not, there are still retail parks with occupational flaws, which will require proactive asset management (and capital expenditure) to rectify. It is in such examples that more opportunistic buyers can differentiate themselves, to take advantage of a more active business plan and shorter term income profiles.

Equally, for more open-minded buyers willing to accept a more granular, active investment play, the shopping centre sector has also shown recent resilience. Historically low rents, reduced business rate obligations and a greater focus on operational costs has created a positive dynamic for retailers in town centre settings. Vacancy is reducing here too and landlords at last have alternatives to incumbent occupiers (even if they are highly unlikely to exercise options to vacate in profitable stores).

In the meantime, though, we expect the weight of low risk capital seeking exposure to the retail sectors to find its home in the hugely resilient retail warehouse and foodstore investment markets."

We like questions, if you've got one about our research, or would like some property advice, we would love to hear from you.

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