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CONVICTION IN ACTION

BEYOND NECESSITY RETAIL: THE UNDERWRITING TEST



Why lease length, tenant strength and rent affordability determine whether necessity retail can deliver durable income

- Contracted rent can overstate exit value
- Equity and senior lenders read the same lease differently

Retail has been through a prolonged period of disruption. E-commerce, the pandemic, inflation and pressure on household incomes have reshaped the sector, but the impact has been uneven.

A grocery-anchored retail park, a regional warehouse and a discretionary shopping center rely on different sources of demand and carry different risks. Treating them as a single market can obscure where income is resilient and where it remains vulnerable. The underwriting question is therefore not whether retail is defensive, but which assets have the tenant economics, lease structures and competitive positions to sustain income over time.

Necessity retail has a natural advantage because demand for food and everyday goods tends to be relatively stable. But that alone does not make an asset resilient. Three factors matter in particular: lease length, the strength of the tenant covenant and rent affordability. Each can offer a different form of protection. A long lease provides income visibility, a stronger covenant reduces the probability of default and an affordable rent makes the lease more likely to survive changes in trading conditions.

The strength of the investment rests on how these factors work together, not on any one measure in isolation.

The retail sector's recent history adds an important dimension to this assessment. Retailers have had to rebuild their business models as spending moved online, distribution costs increased and physical stores took on a different role. The pandemic then placed further pressure on operators already adapting to structural change. Retailers that emerged with viable store networks, established online channels and a better understanding of their fixed costs have demonstrated a degree of operating resilience.

For investors, this makes the tenant's trading history particularly relevant. An established retailer that has operated through several periods of disruption presents a different lens on risk compared to a newer business whose model has not been tested across a full market cycle.

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SHAUN HOSE
Head of UK Equity

DIGGING DEEPER

This is why tenant-level analysis matters. Underwriting needs to consider how many stores an occupier operates and whether individual locations remain profitable. Headline credit ratings provide useful information, but they do not capture the full relationship between a retailer and a particular asset.

A lower-rated tenant occupying a profitable store at an affordable rent may offer greater income durability than its rating initially suggests. Conversely, a strong covenant does not make an uneconomic store viable indefinitely.

Affordability sits at the center of that analysis. A long, inflation-linked lease can appear highly defensive, but contractual income growth only has value if the tenant can cover rental costs. Rent must therefore be assessed against store turnover and total occupancy costs. This relationship is often expressed through an effort ratio, which measures the cost of occupying a unit relative to the sales generated from it. Lower ratios suggest that the tenant has more capacity to absorb rent and other property costs. The appropriate level varies by retail format, particularly for food retailers, where high turnover is accompanied by comparatively thin margins.

The comparison with market rent is just as important. Development costs have increased, which can require a retailer to agree a day-one rent above the prevailing market level for a new store to be viable for the developer. The tenant may be willing and able to pay that rent because the location supports its wider strategy. However, an investor cannot assume that the full contracted rent will be reflected in the asset's value. If the lease is indexed, the gap between the passing rent and market rent may persist or widen. The investor receives the contracted income, but a future buyer may value the property using the lower market rent. What appears to be secure income can therefore create valuation risk at exit.

Lease length also needs to be interpreted in context. Food retailers often commit to longer leases because fitting out and operating a large store requires substantial investment. Moving to another location is expensive. In parts of the out-of-town market, limited new development further reduces the number of alternative sites.

That does not remove the need for a credible downside case. Underwriting should still allow for tenants leaving at lease expiry, followed by a period of vacancy, incentives for a replacement occupier and reletting at the prevailing market rent. The purpose is not to predict the most likely outcome, but to establish whether the investment remains viable if income is interrupted or reset. Store-level turnover and effort ratios help investors judge how probable that downside may be rather than relying on lease length alone.

The analysis also changes across the capital structure. Equity investors occupy the first-loss position and need a detailed view of leasing, tenant relationships and the ability to deliver the business plan.

Shorter leases can create risk, but they can also offer an opportunity to renew at a higher rent or reposition an asset acquired at a lower price. Senior lenders typically place greater weight on income certainty, debt-service capacity and whether the loan can withstand a weaker operating outcome. Both are underwriting the same property, but their exposure to leasing risk is different.

Retail resilience cannot be inferred from a sector label, a long lease or a familiar tenant name. It depends on whether the store works for the retailer, whether the rent remains affordable and whether the asset retains its relevance within a constrained local market. Necessity demand provides a stronger starting point. Detailed tenant and asset-level underwriting determines whether that advantage translates into durable income.

Case study: A more resilient retail mix

The objective was to reposition an established UK retail park from reliance on a traditional anchor towards a more needs-based offer aligned with its family-oriented local catchment. This was intended to broaden the asset's relevance to customers and create a more diversified, resilient base of occupier demand.

This was pursued through active asset management, using catchment analysis to shape the long-term tenant mix and prioritizing occupiers that serve everyday household needs. By combining targeted leasing with the reconfiguration of existing space, we gradually shifted the asset towards a broader range of essential retail categories while reducing its dependence on any single occupier.

Case study provided for illustrative purposes only to demonstrate an example of PGIM's asset management approach in the retail sector. It is not representative of all investments or outcomes, which may vary depending on market and asset-specific factors. There can be no assurance that similar results will be achieved.

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