CHAPTER THIRTEEN: CENTRE DEVELOPMENT DYNAMICS

13.1 INTRODUCTION

Due to the high risk profile of second economy areas retail centre investors and developers have moved into these areas on a trial and error basis. Over time, however, these investors and developershave learned from past experience and are coming up with ever more successful development concepts. Interviews were held with a number of centre investors and developers to obtain insight into lessons learnt and best practice principles. This chapter highlights the findings of these interviews.

13.2 LESSONS LEARNT AND BEST PRACTICE PRINCIPLES

Lessons learnt and best practice principles are discussed in the subsequent paragraphs under the following mainheadings:

- ✓ General centre size;
- ✓ Ownership and land issues;
- ✓ Project cost structures;
- ✓ Tenanting process and mix;
- ✓ Average centre and tenant rentals;
- ✓ Project development yields;
- ✓ Pre-let conditions and lease periods;
- ✓ Centre design;
- ✓ Consumer settlement;
- ✓ Importance of market research;
- ✓ Perceived impact on local businesses;
- ✓ Correlation with SACSC Shopping Centre Hierarchy;
- ✓ General success factors;
- ✓ Major challenges during development;
- ✓ Overall lessons learnt.

13.2.1 GENERAL CENTRE SIZE

- ✓ Most prominent funds and investors regard **14 000m^2 as the absolute minimum** centre size and most prefer **25 000m^2+ GLA** as an ideal size – this affords them the opportunity to incorporate major banking institutions who (for good reason) seem to be reluctant to occupy space in centres smaller than 15 000m^2.
- ✓ However, it should be understood that with the right location, centres of 5 000m^2 to 10 000m^2 could be very successful (it depends strongly on location and current supply).
- ✓ However, a limited number of national tenants would occupy space in a second economy shopping centre of only 5 000m^2 – 10 000m^2 and hardly any would sign up for a smaller centre due to lack of critical mass.
- ✓ The best performing centres (depending on location) are those centres sized at 25 000m^2 retail GLA and larger.
- ✓ It should be understood that specific developers develop specific products enabling them to detain a specific niche in the market.

13.2.2 OWNERSHIP AND LAND ISSUES

- ✓ Land ownership and control, as well as land use rights ("business" zoning) are of paramount importance – the site needs to be controlled, preferably by a single stakeholder or a limited number of (private) stakeholders.
- ✓ Land ownership by a tribal authority or government entity may introduce **timing delays**. Land not zoned or not controlled by a private entity may introduce timing delays of 12 – 24 months and longer.
- ✓ Land owned by government/ Land Affairs produces problems due to the fact that in most cases ownership is unclear – resulting in extreme time delays.
- ✓ Tribal land in some cases is also owned by a number of role players who cannot reach an agreement in terms of the sale of land and costs – resulting in time delays that can stretch on for years.
- ✓ Tribal land does not have title deeds as does municipal land, making it difficult to obtain financial loans.
- ✓ In a number of cases equity to the value of the land is demanded by local tribes.
- ✓ Ownership of these retail centre projects is generally vested in **special purpose vehicles or consortiums.**
- ✓ Smaller developers/investors allow maximum BEE representation of 10% to 20% and larger developers/investors 30% to 35%. It should be understood that BEE representation cannot be compared – some representations are by silent partners and others show active participation in risk taking and value adding.
- ✓ In general BEE representations are higher where the BEE partner contributes financially towards the project.
- ✓ In a number of cases the centre is sold to a BEE consortium rather than providing it with shares in the project.
- ✓ There is also difficulty with the valuation of rural and tribal land.
- ✓ Land ownership issues should be '**uncomplicated'** (verb), as overly complex challenges beyond the norm may simply encourage developers / investors to move on to less complicated projects/sites.

13.2.3 PROJECT COST STRUCTURES

- ✓ The cost of land in rural and township areas is very affordable and represents a very small percentage of the total project cost.
- ✓ However, servicing the land, upgrading the existing services and obtaining the correct land use rights (and required EIA) all increase these costs substantially to approximately 5% to 10% of total project cost.
- ✓ Un-serviced land: the cost of this ranges between R12.50 to R35/36/m^2 – depending on the location of the land.
- ✓ Bulk land township values: These range between R550 to R1 200/m^2 – depending on the location of the land and whether it is zoned.
- ✓ The top structure costs for rural and township areas differ. In general, rural centres represent open plaza type centres with top structure costs of approximately R5 000 to R10 000/m^2. Township centres generally represent enclosed malls with top structure costs of R7 000/m^2 to R13 000/m^2
- ✓ Projects are generally financed by a bank loan – however, only a few developers/investors can obtain 100% loans. In most cases a 60% - 70% loan to value is obtained.
- ✓ Banks have become shareholders in some projects – for example Nedbank.

13.2.4 TENANTING PROCESS AND MIX

- ✓ Most township / second economy consumers insist on first economy tenants, i.e. national tenants typically found in any modern shopping centre in a typical first economy urban setting. Not only is this expectation reasonable, it has become commonplace to tenant second economy shopping centres with such tenants. 'Second rate / tier' tenants (not used here in a derogatory sense but in a strictly financial sense) typically do not succeed in successfully capturing the massive leakage of purchasing power from such markets.
- ✓ Second economy markets, although attracting an increasing share of new developments, present a comparatively higher risk profile, so risk mitigation for the developer / investor is paramount. Risk mitigation strategies typically include the introduction of a high percentage (95 %+ of centre income) of national tenants; development along a major taxi route and incorporation of a taxi rank (including liaison with taxi associations); and the incorporation of national banks as tenants.
- ✓ In terms of tenanting strategies – developers commence with a food anchor – centres less than 20 000m^2 GLA allow for a single food anchor. Centres larger than 20 000m^2 GLA allow for two food anchors – for example Pick 'n Pay and Shoprite.
- ✓ Rural centres are generally anchored by Shoprite. Spar is only viewed as a convenience store and does not represent an anchor in these centres.
- ✓ Food anchors generally require additional space for expansion – e.g. Shoprite requires approximately 4 000m^2 – 3 000m^2 GLA to be built now and 1 000m^2 GLA in storeroom space for future expansion
- ✓ Fashion outlets in rural centres are generally represented by the bottom priced nationals like Pep, Jet and Ackermans, whereas,township fashion outlets correlate to a great extent with urban malls.
- ✓ However, it is important to note a difference in the fact that in urban malls, women represent the key shoppers, whereas in townships, the retail pushers are the male shoppers. Therefore stores like Truworths Man, Markhams etc. outperform stores like Foschini, Milady's etc.
- ✓ In terms of furniture stores JD, Lewis and Ellerines represent the most preferred tenants.
- ✓ In terms of restaurants KFC, Chicken Licken, King Pie and Brazen Head represent the most preferred tenants.
- ✓ Other key tenants include Cashbuild, Build It, Tops Liquor.
- ✓ No entertainment facilities are included in these centres because such tenants underperform and generally fail in these centres.
- ✓ In general, township centres allow for one Chinese trader.
- ✓ The majority of centres are generally characterised by national tenants representing 95%+ of centre income with some centres reflecting lower national tenant representation of 70% of centre income.
- ✓ Most locals are found operating franchises such as KFC, Debonairs etc. Doctors, hairdressers, traditional food outlets, etc are also common.
- ✓ Locals cannot afford to move into formal centres and they do not have the expertise and business knowledge to do so.
- ✓ A centre's success also relies on the investors' ability to attract banks. Second economy areas are strongly characterised by a 'cash culture'. Consumers shop where banking facilities are available and in close proximity to preferred retailers.
- ✓ Banks are frequently accommodated in centres at extremely low rentals and the required high installation costs are shifted onto the investor/ developer's shoulders.

- ✓ Banks are generally also not keen to move into smaller centres, however, government is placing increasing pressure on these institutions to provide the local communities with banking services in these centres.
- ✓ It is also important to note that rural centres are generally characterised by more low-end retailers and township centres by more high-end retailers, e.g. Pep (rural) vs. Markhams (township).

13.2.5 AVERAGE CENTRE AND TENANT RENTALS

- ✓ Rental through rates differ for open and enclosed malls. A rental through rate of R80 to R90/m^2 needs to be achieved in open centres and R100 to R120/m^2 is the general figure in enclosed centres.
- ✓ Lower rental through rates will, in all probability, imply the presence of 'second rate' tenants and may translate into a substandard development. Note: the challenge is further complex and anomalous in the sense that nationals typically pay lower rentals.
- ✓ <u>Grocery anchors</u>: range between R55 and R70/m^2 (township centres R60 to R75/m^2, rural centres R55 to R65/m^2). Spar's rentals are a bit higher, Checkers and Pick 'n Pay are in the middle and Woolworths Food is around R60 to R65/m^2.
- ✓ <u>Clothing tenants</u>: range between R85 and R140/m^2 (excl. VAT) (township centres R65 to R140/m^2, rural centres R85 to R120/m^2).
- ✓ <u>Furniture and furnishings</u>: range between R75 and R80/m^2 (excl. VAT).
- ✓ <u>Entertainment and restaurants</u>: R100/m^2 and higher – KFC recently rented for R175/m^2.
- ✓ Big nationals pay lower rentals. National tenants pay between R55 and R70/m^2, whereas line shops pay rentals of between R200 and R400/m^2.
- ✓ National tenants sign up anywhere to keep competition out. They carry limited risks while all the risk is put on the shoulders of the developer and the banker. With a 20% vacancy rate in a particular centre, the national tenants can walk away from underperforming centres without any further responsibility.

13.2.6 PROJECT DEVELOPMENT YIELDS

- ✓ Due to the higher risk profiles associated with these types of retail centres, smaller investors require paper yields of 11% to 12% to attract their interest, whereas the larger investors require a minimum paper yield[101] of 16% to 17%.
- ✓ There are such vast difference between urban and rural land dynamics and financial models that a direct comparison between yields is not sensible.

13.2.7 PRE-LET CONDITIONS AND LEASE PERIODS

- ✓ Banks and investors require that 70% to 85% of centre income should be secured via pre-letting commitments before development is financed or construction commences.
- ✓ In terms of lease periods – national tenants are required to sign five year leases, locals three years. In the case of purpose-built boxes a minimum lease of 10 years is signed and in some centres the anchor grocery tenants are required to sign 10 year leases.

[101] Note: Paper yield refers to the envisioned yield calculated by investors based on a set of assumptions before investing in a specific project. This paper yield in the majority of cases differs from the actual yields obtained by investments during operational periods.

13.2.8 CENTRE DESIGN

- In terms of centre design, it is evident that most rural centres are developed as open centres and township centres as enclosed malls. When centre size exceeds 20 000m^2 there is a tendency to develop enclosed malls due to the walking distance created by the design.
- Shopping centre design best practices furthermore dictate that a centre will almost certainly not be configured on more than one shopping level – i.e. the site needs to be of sufficient size to accommodate a single floor retail development.
- In terms of parking ratios, there is no uniform indication – the larger developers reflect a parking ratio of 4 bays/100m^2 GLA, whereas the smaller developers reflect 3 bays/100m^2 GLA for township centres and 2 bays/100m^2 GLA for rural centres.
- In general, centre design includes the development of a taxi rank – financed as part of the development. However, if such facilities are provided, buy-in should be obtained from local taxi associations or else these facilities are boycotted and unutilised.
- In general, developers try to formalise informal trade by providing “trade boxes” around the centre. However, if this is not addressed and managed correctly these facilities remain unutilised.

13.2.9 CONSUMER BEHAVIOUR

- Developersindicated that, on average, it takes between 18 and 24 months for consumer behaviour to settle after the opening of a new retail centre in a specific locality.

13.2.10 IMPORTANCE OF MARKET RESEARCH

- The majority of investors conduct market research to test the viability of a proposed centre within a specific locality before centre development commences.
- However, limited in-centre research is conducted in order to ensure consumer satisfaction, healthy tenant performance etc. This type of research is only conducted in the case of centres which are not performing to the required standard.

13.2.11 PERCEIVED IMPACT ON LOCAL BUSINESSES

- The general perception is that formal retail centres do have an impact on local traders such as spaza shops and small scale retailers.
- Developers indicated that these local stores are generally overpriced, impacting negatively on the local community’s income profile.
- Formal retail centres induce a positive impact on the larger community due to the fact that they provide better and more affordable products and services to the mass market.
- Developers therefore feel that the positive impact of a centre weighs more heavily than the small to moderate negative impact it has on the local business environment.
- Local businesses require mechanisms to stimulate business development in order to enable them to be successful in a formal retail environment – Local Government, IDC and Khula must help financially and pay for learnership programmes to make local businesses more efficient and help them learn the culture of re-investing in one’s business. Local retailers should be equipped with basic business management and financing skills.
- Overall, it is undisputed that shopping centres create benefits in preventing leakage of disposable income in township areas, in new business formation and the conglomeration of service based activities in township commercial nodes.

13.2.12 CORRELATION WITH SACSC SHOPPING CENTRE HIERARCHY

- ✓ The larger developers indicated that they are vaguely aware of the SACSC shopping centre hierarchy, whereas the smaller developers indicated that they are not familiar with this hierarchy.
- ✓ In general, developers indicated that this hierarchy is not at all applicable to the second economy areas and the markets in some townships have matured in such a manner that they accommodate more defined and specialised centres.
- ✓ Although most developers would prefer to dominate a particular trade area, there is an increasing number of examples of successfully competing developments in second economy markets characterised by higher consumer demand thresholds, for instance Soshanguve, Soweto, Orange Farm and Sebokeng, where multiple centres have emerged in recent years and coexist in a synergistic manner.
- ✓ In general, developers do not have a specific hierarchy in terms of which they classify their retail centres. The function of the centre depends on its location, current supply and the available consumer income of a specific geographic area. Centres of 20 000m^2 retail GLA can operate as regional centres, and centres of 10 000m^2 retail GLA as community centres.

13.2.13 GENERAL SUCCESS FACTORS

- ✓ The dominant success factors relate to location, critical mass, accessibility, visibility and tenant mix.
- ✓ Critical mass is very important – centres of approximately 15 000m^2 retail GLA are the worst affected if larger centres enter the market, because the majority of these centres are developed on land with limited expansion potential.
- ✓ Shopping centres typically serve as powerful nodal development catalysts and create opportunities for ancillary commercial development. Hence, space should ideally be available to accommodate future expansion.

13.2.14 MAJOR CHALLENGES DURING DEVELOPMENT

- ✓ The major challenges relate to the issue of land:
    - Tribal land is difficult to obtain due to multiple ownership, lack of agreement and the absence of title deeds – resulting in very long waiting periods – in one case a developer waited for nearly 20 years to access certain portion of land.
    - State land is difficult to obtain due to lack of clarity in terms of ownership – municipal land, Land Affairs etc.
    - Land availability in township areas is limited due to the lack of proper town planning and town layouts.
- ✓ Tedious and lengthy processes to rezone the land and EIA approval cause delays in the overall development process.
- ✓ In terms of BEE, locals frequently want to get on board without contributing or performing.
- ✓ Smaller investors are experiencing problems with financing due to the economic recession and access to loans.
- ✓ In terms of tenanting, the largest challenge is to attract banks to the centres, followed by the positioning of tenants within the centre.
- ✓ Other challenges are found during construction: locals complain because they do not get the contracts, but they lack the expertise. This generally results in a number of labour strikes.

13.2.15 OVERALL LESSONS LEARNT

- ✓ Centres should be developed at the right locations with the correct critical mass and tenant composition.
- ✓ Shopping centres typically serve as powerful nodal development catalysts and create opportunities for ancillary commercial development. Hence, space should ideally be available to accommodate future expansion.
- ✓ Local buy-in is critical for the success of the centre and facilities such as taxi ranks and formalised informal trade facilities.

13.3 SYNTHESIS

If one or a number of the above criteria cannot be met, or if expectations (and hence the risk burden) set by the municipality for a developer exceed the norm, it may prove extremely difficult (if not impossible) to attract a reputable developer / fund to such a project.

The subsequent chapter integrates the findings of this chapter with the findings of the previous chapters into a SWOT analysis.