RICS guidance note

RICS professional guidance, Italy

Valuation of shopping centres

1st edition, December 2015

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RICS professional guidance

International standards

Globally recognised high level valuation principles and definitions are now embodied in the International Valuation Standards (IVS) published by the International Valuation Standards Council (IVSC). RICS has long been a supporter of the development of such universal standards, and not only fully embraces them itself, but also proactively supports their adoption by others around the world.

RICS Valuation – Professional Standards 2014, commonly referred to as the Red Book, formally recognises and adopts the IVS by requiring members to follow them. It also complements the IVS by providing detailed guidance and specific requirements concerning their practical implementation.

Member and firm conduct is underpinned through the application of the Rules of Conduct and the Global Professional and Ethical Standards and is assured through a well-established system of regulation. The whole ensures the positioning of RICS members and regulated firms as the leading global providers of IVS-compliant valuations.

RICS guidance notes

This is a guidance note. Where recommendations are made for specific professional tasks, these are intended to represent 'best practice', i.e. recommendations that in the opinion of RICS meet a high standard of professional competence.

Although members are not required to follow the recommendations contained in the guidance note, they should take into account the following points.

When an allegation of professional negligence is made against a surveyor, a court or tribunal may take account of the contents of any relevant guidance notes published by RICS in deciding whether or not the member acted with reasonable competence.

In the opinion of RICS, a member conforming to the practices recommended in this guidance note should have at least a partial defence to an allegation of negligence if they have followed those practices. However, members have the responsibility of deciding when it is inappropriate to follow the guidance.

It is for each member to decide on the appropriate procedure to follow in any professional task. However, where members do not comply with the practice recommended in this guidance note, they should do so only for good reason. In the event of a legal dispute, a court or tribunal may require them to explain why they decided not to adopt the recommended practice.

Also, if members have not followed this guidance, and their actions are questioned in an RICS disciplinary case, they will be asked to explain the actions they did take and this may be taken into account by the Panel.

In some cases there may be existing national standards which may take precedence over this guidance note. National standards can be defined as professional standards that are either prescribed in law or federal/local legislation, or developed in collaboration with other relevant bodies.

In addition, guidance notes are relevant to professional competence in that each member should be up to date and should have knowledge of guidance notes within a reasonable time of their coming into effect.

This guidance note is believed to reflect case law and legislation applicable at its date of publication. It is the member's responsibility to establish if any changes in case law or legislation after the publication date have an impact on the guidance or information in this document.

Document status defined

RICS produces a range of professional guidance and standards documents. These have been defined in the table below. This document is a guidance note.

Type of document	Definition	Status
Standard		
International standard	An international high-level principle-based standard developed in collaboration with other relevant bodies.	**Mandatory**
Professional statement		
RICS professional statement	A document that provides members with mandatory requirements or a rule that a member or firm is expected to adhere to. This term encompasses practice statements, Red Book professional standards, global valuation practice statements, regulatory rules, RICS Rules of Conduct and government codes of practice.	**Mandatory**
Guidance		
RICS code of practice	Document approved by RICS, and endorsed by another professional body/stakeholder, that provides users with recommendations for accepted good practice as followed by conscientious practitioners.	Mandatory or recommended good practice (will be confirmed in the document itself).
RICS guidance note (GN)	Document that provides users with recommendations or approach for accepted good practice as followed by competent and conscientious practitioners.	Recommended best practice. Usual principles apply in cases of negligence if best practice is not followed.
RICS information paper (IP)	Practice-based document that provides users with the latest technical information, knowledge or common findings from regulatory reviews.	Information and/or recommended good practice. Usual principles apply in cases of negligence if technical information is known in the market.

1 Introduction

1.1 Background

The modernisation of the Italian retail industry started with the liberalisation laws introduced in the late 1990s, combined with the parallel evolution of the retail real estate investments market.

More recently, the EU Directive on services in the internal market (2006/123/EC, commonly referred to as the Bolkestein Directive) and recent new liberalisation laws (i.e. opening times) contributed to the removal of the last regional and locally binding rules, based on quantitative (related to market shares) planning of retail settlements, moving lawmakers towards a new qualitative legislation and effectively contributing to further opening the market.

The transformation of the national regulatory framework has been associated with the effects of the recent international financial crisis and recession. These circumstances could continue to affect domestic consumers and purchasing power dynamics and, as a consequence, tenant solvency and rent affordability, thus bringing substantial changes to the shopping centre real estate market.

Given these exceptional circumstances, RICS Italy considers that it is advisable that valuers perform a more detailed and consistent analysis of the factors affecting shopping centre valuations and investment risk assessments.

Shopping centre properties have become increasingly an industry in their own right and a specialised branch of the real estate market, which therefore require more specialised analyses and knowledge, considering the expanding amount of information contained in a shopping centre valuation.

Starting from Red Book principles, this guidance note aims to provide a reference tool for the domestic shopping centre market to improve the level and quality of information available to retail real estate professionals (valuers, advisers, investors, developers and lenders – firms and individuals), when undertaking the valuation of a shopping centre, thus improving market transparency and understanding. The guidance note should also assist in facilitating cross-border shopping centre comparisons and benchmarking related to knowledge, value and profitability performance, highlighting the range of information that RICS recommends should be taken into account.

1.2 Scope of this guidance

The purpose of this guidance note, issued by the RICS Italy Shopping Centre Valuation Working Group, is to assist retail real estate firms and professionals when undertaking shopping centre appraisals and investment assessments and to recommend best practice and actions aimed at standardising the specialised valuation of shopping centres.

The International Council of Shopping Centres (ICSC – www.iscs.org) Europe defines a shopping centre as:

> ‘a retail property that is planned, built and managed as a single entity, comprising units and “communal” areas’.

This definition and other valuation related technical terms and definitions, provided by ICSC and by its Italian subsidiary CNCC *(Consiglio Nazionale Centri Commerciali: National Council of Shopping Centres)*, have been adopted in this guidance.

The CNCC (National Council of Shopping Centres, www.cncc.it) is an across-the-board association that gathers within a single organisation all the private and public entities related in various ways to the industry of shopping centres, commercial parks and factory outlets. The CNCC is also the only representative for Italy on the International Council of Shopping Centres (ICSC, www.icsc.org), a worldwide organisation with over 38,000 members in 75 different countries.

The type of shopping centre that has been assumed as reference for the purposes of this guidance note is the Traditional Shopping Centre as defined by the CNCC, i.e. having a gross leasable area (GLA) of more than 5,000 square metres (which excludes neighbourhood or district shopping centres).

With regard to issues of a general nature, the recommendations in this guidance note can be extended to other types of planned commercial developments (theme-based Shopping Centres, Factory Outlet Centres, Commercial Parks and Lifestyle Centres), for which readers are referred to the CNCC’s specific definitions.

1.3 Effective date

The effective date of this guidance note is December 2015. However, practitioners are encouraged to adopt the practices in this guidance note earlier if appropriate.

2 Core valuation issues

2.1 The subject of the valuation

The subject of the valuation to which this guidance note applies is an existing shopping centre (the asset). The shopping centre shall be assumed, for valuation purposes, to be used in accordance with the classification stated in the general and detailed zoning plans currently in force. The shopping centre shall also be assumed to have obtained all the administrative permits (see definition of business licence), required to operate a retail sale business in a permanent location, a food and beverage business, a leisure and entertainment business, etc.

Unless otherwise indicated by the client (in which case, if the valuer deems it appropriate, a 'special assumption' shall be made – see definition of special assumption in subsection 2.5), the business licence shall be assumed to be held or attributable – through a special purpose vehicle or otherwise – to the owner of the shopping centre.

Therefore, for the purpose of this guidance, the market value determined through the valuation includes the benefit of holding a business licence/authorisation – as is normal market practice. As such, this guidance note does not take into consideration valuations of business licences or permits per se.

2.2 Definitions of terms

The following terms are defined for the purpose of this guidance note.

Anchor stores, draw tenants (CNCC)

> '[Anchor stores or draw tenants] are retail or service businesses that constitute the Centre's main point of attraction and contribute to a significant extent to the generation of consumer traffic. Their nature varies according to the type of Centre: anchors can be medium to large-size general merchandise stores, medium to large-size specialty stores, food and beverage businesses, or leisure/entertainment businesses.'

Asset (unit/real estate complex/portfolio)

The real estate asset (land, buildings, fixed installations and external structures, or a portion or group thereof) that is the subject of the valuation, together with its relevant business licence, excluding any other intangible assets.

Business licence

The intangible asset linked to the asset under valuation, consisting of the set of authorisations required to operate a retail sale business in a permanent location. For shopping centres, the term typically refers to an authorisation for a large retail facility organised as a unit (Article 9, Legislative Decree no. 114 of 31 March 1998).

Catchment area (CNCC)

> 'The area and population from which the Centre attracts visitors and customers. Its size and extension varies according to the nature and prominence of the businesses operating in the Centre, the demographic density of the area, the existence of natural or artificial barriers, the road network that serves the Centre, and the presence of competitors.'

Gross leasable area (GLA) (CNCC)

> 'The gross surface area available for renting. It is made up of the sum of gross commercial surface areas including, in addition to the retail sales area, all the storage, goods handling and processing areas as well as offices of the individual businesses operating within the Centre. It does not include plant and equipment rooms. It is expressed in square meters.'

In market practice, GLA does not include communal spaces.

Communal spaces (CNCC)

> 'All the areas and structures within the centre which are not for the exclusive use of any of the tenants, but are used jointly by all the businesses and by the public. They can be located inside the Centre (malls, access areas, squares etc.), or outside it (car parks, external vehicle and pedestrian traffic areas, communal green spaces, and other decorative and signage elements, totems, external signs, billboards advertising the centre, etc.).'

Communal spaces typically include restrooms, centre management offices, technical rooms, etc. While excluded from GLA measurement, some components of communal spaces are potentially income generating areas (e.g. temporary leases, advertising banners, etc.).

Footfall

The term footfall refers to the number of shoppers visiting a store or retail business over a given time period. Being linked to the business' sales revenues, footfall trends can

provide a useful growth indicator and help investors to understand the increase (or decline) in a retailer's sales.

(To determine the potential effects on sales revenues, it is important to correlate the average receipt value to the footfall. In certain locations other than non-urban shopping centres characterised by intensive passage, e.g. high streets or commercial facilities situated within modal exchange centres (railway stations, airports, ports, etc.), the average receipt value per individual visitor may be significantly lower.)

Merchandising mix

Merchandising mix is defined as the breakdown into different categories of all the businesses (whether retail, food and beverage, services, or other) operating in a shopping centre, according to distribution format and product categories.

In summary, the term distribution format refers to:

- large general merchandise stores (hypermarkets, superstores, supermarkets, etc.)
- large specialty stores
- medium-sized stores
- retail/food and beverage/service/other units.

For retail sales businesses operating in a permanent location, this classification is based on different sales surface area thresholds, as set forth in Article 4 of Legislative Decree no. 114 of 31 March 1998 (reform of the regulations governing the commercial sector in accordance with Article 4, paragraph 4, of Law no. 59 dated 15 March 1997), unless otherwise governed under regional regulations.

However, it should be noted that in the local practice of the specialised commercial asset market, the distribution formats listed above are mainly defined according to GLA and on the basis of different thresholds than the ones set by law, taking into account synergies and consistency of commercial operation processes within the scope of a shopping centre's distribution framework.

Product categories (for retail, food and beverage and service units) include, but are not limited to, the following:

- apparel, footwear and accessories
- restaurants/food and beverage
- consumer electronics
- sporting goods
- do it yourself
- furniture
- gifts and jewellery (personal goods)
- health and wellness (personal goods)
- specialty retailers (telephones, games, bookshops)
- houseware and interior design (household goods)
- entertainment
- services.

In designing a shopping centre, the merchandising breakdown should be balanced on the basis of the propensity for consumption of the population in the centre's catchment area.

The centre's attractiveness depends largely on this breakdown and on the mix of distribution formats and product categories.

Minimum guaranteed rent (MGR) (gross, per year)

The fixed rental amount, both for business leases and for property leases, before non-recoverable costs (costs to be incurred by the asset, see section 6) and structural vacancy rate (if applied) (see subsection 6.1.1, Ordinary management, for definition). By its nature, this component is independent of sales revenues, and therefore of the shopping centre's performance.

Variable rent – TOR (turnover rent)

The rent component (variable according to turnover) of a commercial unit subject to business lease agreement, if provided for therein. The variable rent may be payable in addition to the MGR, if a calculation of the incidence rate on turnover shows that the resulting rent is higher than the MGR. For some tenants with a higher contractual power or some types of commercial facilities (e.g. factory outlet centres) the rent may only include a variable component, without MGR.

Temporary lettings (CNCC)

> 'Temporary lettings or mall income: the term temporary letting refers to all exhibition activities, or in some cases sales activities, conducted on communal areas of moderate size in the commercial gallery, parking areas or vacant units. The typical duration of these leases is 2–3 weeks, and they are regulated by a concession agreement.'

Rent roll

A document showing the rental details of all the units that make up a shopping centre (as defined below), operating at the date of valuation.

Traditional shopping centre (CNCC)

> 'An architecturally and functionally homogeneous group of retail businesses planned and developed by one or more entities as a unit, including integrated support activities for the serving of food and beverages and the provision of services, equipped with communal spaces and services, and permanently managed as a unit with a view to generating synergies that will result in added value compared to the individual units that compose it.'
>
> 'A **shopping centre** should therefore meet the following requirements:

- minimum GLA determined according to the type of centre
- planned, developed and architecturally designed as a unit
- multiplicity of business labels and/or diversified services
- existence of general merchandise or specialty anchor stores acting as drivers and capable of ensuring a permanent force of attraction
- the facility should include a parking area adequate to the shopping centre type and size and the expected visitor volume
- composition and organisation of a diverse offering of products and services, predetermined on the basis of local market conditions by a single entity which may be in charge of marketing and of the control and adjustment of the merchandising mix
- management as a unit carried out by a designated entity, responsible for providing all the services related to real estate management, business management, shopping centre supervision, and ongoing promotion of the common image
- presence of a "consortium" or "association" of businesses operating within the complex, and/or of an entity acting as a single interface to government authorities for the purpose of obtaining authorizations.'

2.3 Value bases (market value, market rent, etc.) and valuation methods

2.3.1 Value bases

Shopping centres are usually valued to market value. The bases of market value, and market rent where required, shall be in accordance with the definitions in the *RICS Valuation – Professional Standards January 2014*. This guidance note also applies to valuations reported at fair value under International Financial Reporting Standards (IFRS). (See subsection 2.4.2 for additional guidance on the application of highest and best use (HABU) to shopping centres.)

- **Market value: VPS 4 paragraph 1.2**

  Valuations based on market value adopt the definition and conceptual structure provided by the International Valuation Standards Council (IVSC).

  Market value: 'The estimated amount for which an asset or liability should exchange on the valuation date between a willing buyer and a willing seller in an arm's length transaction, after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion.'

- **Market rent: VPS 4 paragraph 1.3**

  The term market rent refers to 'the estimated amount for which an interest in real property should be leased on the valuation date between a willing lessor and a willing lessee on appropriate lease terms in an arm's length transaction, after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion.'

2.3.2 Valuation methods

While a range of valuation methods and approaches are available, the established industry practice in Italy is to use the income capitalisation approach (discounted cash flow or DCF), as this is believed to be the best valuation approach to determine the market value of a shopping centre.

In discounted cash flow analysis, the future net cash flows generated by the asset and expected over a certain period of time (typically 10 to 15 years) are discounted at the valuation date by applying an appropriate discount rate representing the risk/return profile of the real estate investment. At the end of this period, it is assumed that the asset will be sold (exit value) at a value obtained by capitalising the income for the year subsequent to the end of said period, through a market capitalisation rate deemed appropriate also on the basis of investments comparable to the one in question.

As it diverges from the strategies of opportunistic players whose investment/divestment time frames are much shorter, this time horizon generally allows operators to conduct appropriate asset management activities, including re-letting of the units, as well as capital expenditures, if required, to improve profitability, so as to achieve full-capacity operation and divestment of the asset.

Discount and capitalisation rates should be consistent with the degree of uncertainty inherent in the rental cash flows to be discounted or capitalised. This applies in particular to temporary leases and variable rent components linked to sales revenues. (The condition of 'full-capacity' operation should be viewed as an assumption in that, given the high number of businesses operating in a shopping centre and therefore the high number of contracts each having a different duration, it is virtually impossible to identify the time when a centre can be considered to be operating 'at full capacity'.)

For general guidance on DCF see the RICS guidance note *Discounted cash flow for commercial property investments*, 2010.

2.4 Appraisal assumptions and limiting conditions

2.4.1 Appraisal assumptions

The appraisal assumptions adopted are crucial for the determination of a shopping centre's market value.

As with other commercial properties, the peculiarity of a shopping centre lies in its ability to generate income from the lease of rentable spaces. This income is directly or indirectly (variable rent v minimum guaranteed rent) related

to the sales revenues that can be earned from the retail activities operating in the centre, based on a sustainable rent to sales ratio threshold, below which the business is no longer profitable.

As a result, a shopping centre is an extremely complex real estate product, with a large number of variables interacting to affect its economic performance. Factors that play a substantial role in this respect include, but are not limited to:

- location (visibility, accessibility, dominance within its catchment area)
- competitors' geography
- presence of new initiatives able to penetrate the target market
- a well-balanced merchandising mix
- positioning of anchor stores
- commercial attractiveness of the tenants
- high design value and
- aspects related to management and marketing.

Market value determination is usually based on the assumption that the asset will be sold as a whole with the benefit of all existing leases, considering that in most cases the asset ownership is a single owner or a limited number of owners (typically two, one owning the food anchor and the other the gallery). If the number of owners is larger, the assumption of a sale as separate interests may be a consideration. Such disaggregation requires specific consideration concerning the synergies/opportunities or management issues arising from asset grouping.

Additionally, as stated in the scope of valuation definition, the market value of a shopping centre includes the value of business permits, without which the shopping centre would be unable to operate.

The definition of market value under VPS 4 paragraph 1.2 refers to 'proper marketing' as a prerequisite for finalising the transaction. Sales of assets that have not been properly marketed may be '**Valuations reflecting an actual or anticipated market constraint, and forced sales**', a condition that may have to be considered as a special assumption (see VPS 4 paragraph 4).

Although it should contain a general description of the zoning situation at the date of the appraisal, a shopping centre valuation typically assumes that the asset is used in accordance with the classification stated in the zoning plan currently in force. The industry practice for the preparation of a valuation report does not require specific investigations with respect to zoning: that would usually pertain to a due diligence. Any obvious and blatant inconsistencies between the zoning plan and the current use of the asset should be duly highlighted in the appraisal as well.

2.4.2 Highest and best use

According to this principle (set forth by the International Valuation Standards Committee – IVS Framework paragraphs 32–34), the highest and best use of an asset is, among all those that are technically possible, legally permissible and financially feasible, the one use that is potentially able to maximise its value. This use may differ from the current use of the property.

The valuation of a shopping centre is generally based on the asset's situation with respect to leases, distribution layout, merchandising mix, etc. at the valuation date.

Within the principle of highest and best use, the potential for possible extensions (for instance expansion over adjacent land in the same ownership) should be taken into account, providing separate valuations.

Unless specifically requested, the valuation should not take into consideration any special assumptions (see subsection 2.5) that would result in changes and/or improvements (upside) to the centre, resulting from significant modifications of the distribution layout and merchandising mix, such that may lead, in principle, to a strategic market repositioning of the centre. These aspects typically pertain to feasibility studies. Where valuations are provided to reflect such special assumptions they should be clearly set out. Depending on the purpose of the valuation it would be good practice to give an indication of the difference between the valuations with and without the special assumptions.

2.4.3 Summary of limiting conditions and assumptions to be included in the terms of engagement (VPS 1)

- Date to which the valuation opinions and conclusions refer.
- Purpose of the appraisal.
- Conformity with valuation standards.
- Valuer's professional qualifications.
- Full appraisal (including on-site inspection) or desktop analysis without asset inspection.
- The indicated values do not include VAT.
- The valuation opinion provided is based on market conditions and on the currency's purchasing power at the reference date.
- Assumption of the assets' surface areas and dimensions as provided by the client or verification by the valuer. Note that according to industry standards these GLA data are derived on the basis of information provided by the client, unless the latter specifically requests their verification. Accordingly, dimension information is assumed to be complete and true, and therefore not requiring verification through on-site inspection and measurement.
- Information concerning asset surface areas and dimensions are provided for the sole purpose of allowing identification of the asset under examination. Such information shall not be used in ownership transfer deeds or any other legal document unless accurate checks are performed in advance by a notary or lawyer.
- The asset is assumed to be compliant with applicable environmental regulations.

- No soil analysis is carried out.
- The asset is assumed to be compliant with zoning requirements and to have obtained the necessary permits.
- Ownership rights are assumed to be exercised within asset boundaries, and it is assumed that no violations of third-party ownership rights or trespassing exist.
- Charges arising from a sale of the asset (including tax charges) are generally not considered. In particular, with the exception of assets purchased or held by entities like Italian real estate funds, which benefit from a low-tax regime upon purchasing the asset, in the large majority of cases of industry practice the purchase/transfer of these assets takes place through shares of an SPV (special purpose vehicle): therefore the transaction occurs in the form of a share deal. Clearly, this method is not subject to the aforesaid mortgage and Land Registry taxation, but to different taxes essentially proportional to the capital gain realised from the transfer. Considering the multiplicity of the fiscal and tax structure of the players involved in a transaction, it is virtually impossible to determine an ordinary DTL (deferred tax liability). Therefore, it appears to be justified to exclude these components in assessing the market value of the asset, in line with the Italian market practice.
- No opinions are expressed with regard to the asset's structural integrity, including its compliance with special requirements such as fire prevention, earthquake resistance and workplace safety, or to physical defects that are not apparent to the valuer.

2.5 Documents to be requested, special assumptions and minimum content of valuation reports

2.5.1 Documents to be requested for the valuation

The documents that should, in principle, be requested from clients to conduct the appraisal include but are not limited to those listed below. In drawing up the appraisal report, it is essential to include a disclaimer as to the correctness of the information received by the valuer from the client and assumed to be accurate without carrying out independent checks, unless expressly requested to do so. (See VPS 3 paragraphs 7 (g) and (h).)

- Rent roll (a summary table listing the names of tenants and the amounts due) and copies of model lease contracts
- other sources of income (temporary leases, advertising, variable rents, etc.)
- asset surface areas and dimensions (in particular GLA)
- plans of the asset
- breakdown of footfall and sales revenues by individual operator
- non-recoverable costs: property tax, insurance, etc.
- incurred and planned capital expenditure
- common area maintenance fees
- due diligence for past activities
- other relevant documentation.

In addition to the documents required for the appraisal of investment properties with other uses, the valuation of shopping centres should include data concerning the economic performance of each commercial unit. Valuers should therefore determine the exact surface area and business category of each unit with the aid of an explanatory plan of the centre indicating the individual units and their numbering, which should match the rent roll, the actual GLA occupied by each tenant and the related business category, as well as the brand (label, trademark). This identification allows valuers to determine the centre's commercial positioning through an analysis of the percentage distribution of each business category.

Footfall data are especially relevant and specific to shopping centres. This information allows owners/managers to identify higher footfall times and periods (enabling them to launch promotions and events to improve visiting rates in other periods), and valuers to ascertain:

- whether the centre's attractiveness is on the rise or on the fall over time and
- whether any reduction in sales revenues may be associated with decreased footfall rather than a declining propensity for consumption.

Other significant data for valuation purposes concern surface areas. According to industry practice, the asset's areas data are provided directly by the client. Conversely, information concerning the overall surface areas only has a secondary importance (for valuation purposes, but not for description purposes), other than to determine the cost of rebuilding as new (useful as a reference to estimate insurance costs and reserves to be allocated for extraordinary maintenance).

2.5.2 Special assumptions

In accordance with VPS 4, assumptions and special assumptions must be agreed and confirmed in writing to the client before submitting the report. These assumptions can only be adopted if they can be considered reasonably realistic, relevant and valid with respect to the specific circumstances of the valuation.

For example, aspects that are frequently not analysed in detail in shopping centre valuations (and in other real estate appraisals as well) include:

- ownership and origin
- correct Land Registry status
- compliance with zoning requirements
- availability of all the administrative permits required to operate the retail businesses and

- environmental conditions.

All of these checks and analyses are left to be carried out during the technical due diligence procedures. Consequently, the valuation report should contain specific assumptions, pointing out that certain aspects have not been reviewed and referring to the relevant due diligence reports, if applicable.

Another aspect that is often underestimated is the existence of any delayed or outstanding rental payments. It is not unusual to find delays or even chronic non-payment of rent. These aspects are difficult to take into account within a valuation, other than by considering a specific average annual provision. In this regard, industry practice provides for an average aggregate amount of the centre's outstanding rents, which should be reflected in any cautionary assumptions, for example in the typical rate of unit vacancy to be applied to annual gross revenues from rents.

2.5.3 Minimum content of valuation reports

Valuation reports must comply with VPS 3 and should include references to the following points where applicable together with the matters referred to in subsection 2.4:

- date of appraisal, purpose of appraisal, conformity to valuation standards, professional requirements
- on-site inspection/desktop analysis
- documents supplied for the valuation
- special assumptions
- asset location
- catchment area
- asset description
- areas data
- revenues
- costs
- real estate investments in the commercial segment (and comparables, if available)
- asset SWOT analysis (SWOT analysis states the characteristics of the shopping centre under valuation, describing and justifying the assumptions adopted in the appraisal. SWOT is an acronym for strengths, weaknesses, opportunities and threats of the asset under valuation.)
- valuation criteria and considerations
- development of the valuation calculation
- value conclusions.

3 Location factors

3.1 Location and description of the surrounding context

3.1.1 Location

As with any type of asset, the location of a shopping centre is the number one consideration in real estate. If there is one thing that remains unchanged during the economic life of a shopping centre it is the fact that you cannot move its location to somewhere else, i.e. you can never disassociate buildings from land.

Despite its being an address, the location of a shopping centre is characterised by being dynamic rather than static: factors like accessibility improvement, construction of adjoining developments, and inauguration of competitor schemes, among others, may have a direct impact when assessing the 'quality' of a shopping centre's location.

The factors described below should be photographed at the date of valuation but the future evolution of all these factors should also be analysed when assessing the location of a shopping centre.

Below are set out the most relevant topics to consider when analysing the location of a shopping centre, however, the key element in assessing the adequacy of a shopping centre's location is understanding whether the area of reference is an established retail destination. For a location to be established as a retail destination, it should possess a cluster of retail characteristics (physical, occupational and even emotional) that are suitable to attract a large catchment population. Note that a location may be established as a retail destination on the basis of the existence of a single shopping centre, which in most cases can be considered a dominant shopping centre.

3.1.2 Context

In most cases, the context that surrounds a shopping centre is strongly correlated with the type of shopping centre. As a general rule, regional shopping centres are situated in peripheral or out-of-town areas while smaller shopping centres or retail galleries (defined by ICSC as neighbourhood centres) are usually characterised by in-town locations.

The major criteria to describe the context of a shopping centre can be divided into:

- Description of geography: coastal; inland; island.
- Description of the type of location: in-town; peripheral or edge-of-town; out-of-town.
- Description of the area of reference: urban/suburban area – specifying predominant building density and existing uses (residential, office, retail, industrial, hospitality, etc.); rural settlements (villages, hamlets, etc); rural (green fields, cultivated fields, etc.); mixed; new developments.
- Statement of any other points of interest that may be considered an added value to describe the context or even to justify an additional visitor flow to the shopping centre (proximity of monuments, religious destinations, leisure infrastructures or locations, etc.).

3.1.3 Accessibility

The accessibility of a shopping centre is expressed through the description of the communications that provide ease of access to the subject asset.

The description of accessibility is normally divided into:

- local road network and connection with major highways and
- public transport (bus, metro, rail, ports/harbours and airports).

Future accessibility development in the short to medium term should also be considered and referred to.

3.1.4 Demography characterisation

Characterisation of the demography offers a profile of the population comprised in the potential catchment area of the shopping centre. Characteristics such as the number of inhabitants (of the region and municipality) or the population density rate are considered important in assessing the location of a shopping centre. Aspects such as the average age, gender and even number of foreigners in the municipality/region provide additional elements to characterise the catchment population.

3.1.5 Local and national economy

A characterisation of the national and local economy provides the economic basis to determine the income profile of the population comprised in the relevant catchment area. An analysis of the economic data should address the following characteristics:

- main activity sectors (historical, current and emerging industries/activities)
- local unemployment rate v national average
- GDP analysis for both local and national population
- number of firms operating in the province
- any other relevant economic data that may help to characterise the local population.

An analysis of the economy at both levels is helpful not only to ascertain the spending power of the catchment population (allowing for a more accurate estimate of the occupational market of the shopping centre) but also to determine the level of interest from the investment market at a national and international level.

3.2 Catchment area

3.2.1 Area of attraction

The catchment area of an existing shopping centre is defined as the geographic area (or area of attraction) over which the shopping centre under examination is deemed to extend its influence in consideration of its size, product offering, and density of the existing commercial offering.

Within this guidance note, the terms ‘catchment area’ and ‘area of attraction’ are used interchangeably and their meaning is considered to overlap.

An estimate of a shopping centre’s catchment area allows the determination of the number of its potential customers.

An existing shopping centre’s catchment area is generally estimated on the basis of the definition of certain isochrones which, depending on the centre’s location and predetermined travel times, delimit the areas from which the asset under examination can be reached at the same time. By way of examples, the isochrones generally adopted for the different types of shopping centres are shown below.

Planned commercial development	GLA (CNCC classification)	Reference isochrones (vehicular minutes)
factory outlet centre		60–90
big-box stores (large specialty stores)		up to 60
regional shopping centres	> 80,000m^2	45–60
large shopping centres	40,000–79,999m^2	30–50
medium-size shopping centres	20,000–39,999m^2	25–40
small-size shopping centres	5,000–19,999m^2	20–30

Once the isochrones are drawn using specific GIS (geographic information system) software, it will be necessary to check the number of residents for each isochrone in order to obtain an indication of the number of potential consumers. The more advanced geomarketing software applications allow more accurate estimates not only of the number of potential consumers in the area, but also of the latter’s propensity for consumption and the centre’s potential market shares.

In general, the main elements to consider when estimating a shopping centre’s attractiveness can be summarised as follows:

- **Centre’s size and merchandising offering**: a regional centre or a large shopping centre will be able to attract visitors from longer distances than a small neighbourhood centre with a more limited merchandising offering.
- **The existence of natural or artificial barriers**, such as rivers, mountain ranges, large communication routes, etc., which could make it difficult for the residents of certain areas to travel, and therefore to reach the centre.
- **The existing road network**, which facilitates or hinders fast travel.
- **The centre’s merchandising offering compared to the main competitors**: the presence of large or medium-sized specialty stores, innovative brands, and areas with highly appealing labels increases the centre’s attractiveness.
- **Presence or absence within the centre of elements able to improve its attractiveness**: for example, the presence of a multiplex theatre or other entertainment businesses, restaurants and leisure facilities are factors that potentially lead to an extension of the centre’s opening hours.
- **The residents’ propensity to travel**.
- **The existence of any psychological barriers to reach the centre**, for example, shopping centres located in socially problematic or unsafe areas.

A shopping centre’s catchment area does not coincide with the resident population, but may also include occasional visitors such as tourists, holiday home owners, business district workers, off-site students, users of large urban functions (sports facilities, hospitals, courts of law, research centres, etc.).

Aspects to consider also include any factors that, in the future, could change the centre’s catchment area (such as the construction of new road system to access the facility, or the opening of new competing shopping centres, whose areas of attraction could overlap the one estimated for the centre under valuation, reducing the latter’s attractiveness).

Once the catchment area has been determined, in terms of number of potential consumers, it is advisable to carry out an analysis of the area’s key socio-economic indicators, such as:

- demographic structure of the population aimed at measuring the weight, within the estimated catchment area, of the age groups with the highest spending ability
- the area’s income per capita
- consumptions per capita and
- unemployment rate.

3.2.2 Analysis of present and future competition

Analysis of competition means the identification of the major commercial facilities (both existing and planned) whose location, size and merchandising offering may cause it to exercise its power of attraction in the same area, or part of the area, where the asset under

examination is located. For each commercial facility, the elements to be considered in this analysis include:

- **Size of the centre and of the merchandising mix**: The analysis should be limited to retail schemes that are comparable, in size and number of tenants, to the one under analysis. Large shopping centres with a rich product offering usually have a greater attractiveness compared to small neighbourhood centres, whose attraction is mostly limited to the district or urban area next to which they are located.
- **Prevalent merchandising mix**: The analysis should focus primarily on retail schemes having a merchandising mix comparable to the one of the centre under examination. For example, a centre with a prevalent offering in the area of entertainment and leisure, and which is therefore addressed to a specific target market, cannot be compared to a traditional shopping centre aimed at meeting diverse consumer needs and patterns. The same applies to factory outlet centres, which meet very specific purchasing needs.
- **Quality of the merchandising mix**: What should be analysed is the merchandising mix of the competing retail scheme, examining whether or not there are large/medium-sized speciality stores, attractive retail labels, or brands of national or international renown.
- **Attractiveness of the food anchor (if present)**: A review should be performed of the commercial appeal of the food anchor, which could be a highly attractive label.
- **Location of the competing retail scheme and distance from the shopping centre under examination**: The analysis should consider the location of the competing facility with respect to the centre under examination, its distance from the latter, and its distance with respect to the main residential hub within the area.
- **Existing road network and expansion plans for the future, if applicable**: The analysis should examine travel times within the estimated catchment area, and whether it is easier to reach the competing centre compared to the one under examination.

In the case of shopping centres located in the suburbs, the '**historic centre**' represents one of the competitors to be taken into consideration in analysing the competition, particularly for those suburbs where the density of retail, food and beverage, and service businesses results in a strong attraction capability. Particularly in larger cities (with a multiplicity of commercial districts), in-town shopping centres compete with the nearest high streets.

4 Asset description: asset surface areas

4.1 Asset description: technical report

4.1.1 Description

The following checklist, intended to be as comprehensive as possible, is of the content that should be included in a shopping centre description when preparing a valuation report.

- **Scope of the valuation**

  Provide details of any inclusions and exclusions (e.g. multiplex theatres yes/no, etc.).
- **Date of on-site inspection**
- **Client**
- **Address**

  Indicate the municipality, province, location, street or square and street number, and the name of the shopping centre (label).
- **Context and land plot description**

  Describe the physical characteristics and boundaries of the land plot on which the building stands, and provide details on the surroundings (e.g. adjacent streets, use of the neighbouring areas, presence of developments nearby). Note any other specific elements considered relevant for the type of asset under examination (e.g. presence of other commercial facilities in the immediate vicinity).
- **Surface area of the plot**

  Specify the amount of uncovered surface area.
- **Shopping centre description**

  A short description including information on shopping centre layout and comments on the external area. The description should provide all the elements required to allow readers to form an opinion on the 'quality' of the asset.
- **Year of construction or latest refurbishment**

  Specify whether the refurbishment was complete or partial.
- **Construction characteristics**

  Foundations, load-bearing structure, roofing, perimeter walls, windows and walls, flooring, false ceilings, interior finishes, etc.
- **Systems and installations**

  Water and sanitary system, electrical system and motive power, air-conditioning system, photovoltaic system (if any), fire prevention system, elevator systems, anti-intrusion system, communication system, video surveillance system, shoplifting prevention system, etc.
- **Gross surface area and GLA of the building**

  Broken down by levels.
- **Number of levels**

  Number of above-ground and underground levels, indicating the main use of each level.
- **Connectors**

  Horizontal and vertical, specifying the exact number of moving walkways, escalators, elevators and goods lifts.
- **Composition and spatial organisation of the commercial offering**

  Merchandising mix: critical analysis taking into consideration accesses (parking areas and vertical connectors), location of the anchor and of large and medium-sized specialty stores (even if not included in the scope of the valuation).
- **Communal services for visitors**

  Mall, information offices, restrooms, play areas, outdoor equipped areas, etc.
- **Number of stores**

  Subdivided by level and grouped by size categories.
- **Key brands**

  Subdivided by merchandising category.
- **Number of entrances**

  From the outside or from the parking areas, specifying the type of entrance and orientation with respect to the flows.
- **Number of checkouts (hypermarket or food anchors)**

  Specify the number of quick checkouts, self checkouts and checkouts for disabled people and/or expectant mothers.
- **Preparation and storage areas (hypermarket or food anchors)**

  Processing areas (meats, fishery products, cold cuts, bakery, etc.), storage areas, cold storage room, filter areas, etc.
- **Number of parking spaces**

  Specify whether covered (indicate the type of connection with the shopping centre), and uncovered (indicate whether with or without shelters).
- **Outdoor commercial activities**

  Plant nurseries, workshops, service stations, newsagent's shops, fast food restaurants, etc.
- **Entertainment**

  Presence within the shopping centre of multiplex theatres, game arcades, or FEC (family entertainment

centres): specify location and distance, common accesses (if any), common parking areas, etc.

- **Expansion potential**

  In terms of zoning plan and of opportunities.
- **Notes and comments.**

Attachments:

- General layout plan
- Layout by level
- Site map (expanded)
- Site map (detailed)
- Aerial photo (expanded)
- Aerial photo (detailed)
- External photographs
- Internal photographs
- Photographs of details.

4.1.2 Standing and state of repair

- **Quality level of the finishes**
- **State of maintenance**
- **General standing.**

4.1.3 Cadastral identification

- **Municipality**
- **Land Registry:**
  - sheet
  - parcel
  - cadastral size
- **Buildings Registry:**
  - sheet
  - parcel
  - subordinate
  - category
  - class
  - income
  - cadastral size
  - notes and comments

Attachments:

- Map extracts
- Land Registry inspections
- Cadastral plans
- Building Registry inspections.

4.1.4 Zoning situation

In line with the assignment and the information received, provide a description of the asset's zoning situation and indicate the information sources.

- **Details of approval of the city plan currently in force and/or adopted**
- **Extract from the Technical Standards**
- **Extract from the Zoning Table**
- **City planning conventions**
- **Obligations and easements**
- **Notes and comments**.

4.2 Asset surface areas and dimensions

- **Methods for acquiring surface area data**

  Indicate the source of the surface area information used and the limits of the investigations performed (e.g. whether the surface areas have been verified, on a sample basis or otherwise, through measurement of scaled plans; whether layout plan surfaces have been verified through on-site measurements), in compliance with the analysis level required under the assignment.
- **Buildable land area**

  The term generally refers to the cadastral area with the exclusion of any expropriated portions not yet formalised.
- **Gross usable area (GUA)/gross floor area (GFA)**

  These measures indicate the size of usable spaces that is relevant for the assignment of building portions; all general city planning instruments indicate the measurement methods and the items to be excluded from computation.
- **Gross surface area**

  The surface area of each level, as measured within the external profile of the perimeter walls of the buildings and at the centre line of the masonry bordering third-party properties.

  In addition to the GLA relating to the gallery and anchor stores (if any), the gross surface area of a shopping centre includes the horizontal connecting areas ('mall'), the technical rooms, the management offices and the parking areas.
- **Gross leasable area (GLA)** (see definition in subsection 2.2)
- **Sales surface area** (Article 4, subsection 1, letter c, Legislative Decree no. 114 of 31 March 1998)

  The sales surface area (SSA) of a retail business is the area used for sales, including the portions occupied by counters, shelves, etc. It does not include spaces used as warehouses, storage spaces, processing areas, offices and services.

  It is the area that is legally authorised by business licences for medium to large sales surface areas; this measurement affects the size of the centre, as the GLA is determined, at the time of developing the design, by increasing the SSA according to considerations that are functional to the conduct of sales activities (incidence of warehouses, processing areas, etc.), or on the basis of percentage limits set by regional sector regulations.

- **SSA to GLA ratio**

  In the case of a traditional shopping centre, ratios below 70% generally indicate an excessive incidence of areas not authorisable for retail sale in a permanent location (e.g. areas used for services, crafts, catering, leisure, etc.)

- **GLA to car parking spaces ratio**

  This ratio is calculated by dividing the GLA, expressed in square metres, by the number of parking spaces.

5 Rent roll (lease status)/incomes

5.1 Lease status/income flow

In the valuation of a shopping centre, the asset's lease status is crucial in determining its ability to generate income.

The value of a shopping centre depends largely on the income flow generated by the asset and on the long-term security and stability of this flow.

5.2 Documentary sources

The documentary sources from which the required data are derived should be cited. For shopping centres, in particular, the prime document is the *rent roll*, which shows the following information for each asset:

- tenant
- brand
- merchandise category
- GLA
- type of contract (property lease, business lease, gratuitous loan, etc.)
- effective date
- first due date
- second due date
- rent in effect at the date of valuation
- rent at full capacity (headline rent)
- ISTAT adjustment
- stepped rents
- right of early termination (break options)
- other income (temporary lettings, corners, billboards, antennas, photovoltaic panels, radio/television circuits, petrol stations, etc.).

5.3 Analysis

In analysing the lease status of an existing shopping centre, special attention should be given to the following.

Tenant mix

It is advisable to review the centre's merchandising mix and correct balance between categories, as well as the label profile (by brand and type). Specifically with respect to the label profile, valuers should analyse the presence within the centre of nationally or internationally renowned labels and the weight of local business operators in the gallery. The comment about the tenant mix should concern tenant quality and their attractiveness to consumers.

Type of tenants operating in the shopping centre

A first tenant classification can be made on the basis of the national, international or local prominence of their brand:

- International brand: characterised by local as well as international presence.
- National brand: characterised by presence in the national market only.
- Local brand: tenants known in the regional, provincial or municipal market. They usually have a small number of sales outlets, and their renown is generally limited to a restricted catchment area.

A centre with a higher number of national and international tenants is generally considered stronger and more attractive than a centre with a high number of local tenants. This consideration is often confirmed by the tenants' performance. However, some local tenants are very well-known in the relevant catchment area and their attractiveness may contribute to the good performance of the shopping centre.

A second tenant classification can be made on the basis of whether the tenants operate under their own brand or under a franchising agreement. Based on this criterion, the following distinctions can be made:

- Direct tenants, for sales outlets belonging to a chain and managed directly by the parent company. These tenants are generally perceived as having a lower risk profile, and their purchasing and management benefit from scale economies.
- Master franchisee or franchisee tenants, for sales outlets belonging to a chain and managed by a franchisee. As a general rule, these tenants have a medium risk profile, as in addition to rent their expenses may include *royalties* to be paid to the franchiser as supplementary cost. Some master franchisees benefit, to a lesser extent, from the same advantages as direct tenants.
- Independent tenants, i.e. retailers who do not belong to a chain of sales outlets.

Size of the units

During the valuation process, the valuer should analyse the incidence, on the centre's overall GLA, of retail and restaurant units, medium and large box stores, and anchors.

The letting risk is usually lower if a concentration of more easily rentable small-size units prevails. In a retail park, the desirability of the appraised asset is higher if the proportion of anchor stores is greater.

Contractual profile and term profile

For income generating properties, the analysis should cover:

- The type of contract used (business leases v property leases), keeping in mind that business leases are the most commonly used type of agreement in shopping centres, and typically have terms of 5 to 7 years. (**Business unit**: a complex of assets organised for the operation of a business enterprise; the business unit is generally the sum of the property and the relevant business licence.) This type of contract can only be used if the owner of the asset is also the holder of the business licences. These contracts provide the owner of the asset with greater control on the lease status of the centre, allow more frequent renegotiation of rentals (potentially after 5 instead of 12 years, as in the case of lease agreements), and do not envisage goodwill compensation, which the owner must pay to the tenant if the lease agreement is not renewed. Property leases are generally used for businesses other than retail in permanent locations or restaurants (services, service crafts, etc. such as hairdressers, beauty salons, etc.). In addition to these two types of contracts, gratuitous loan agreements are also used in some cases. In this type of contract, use of an asset is granted free of charge for a certain period of time. This solution is often used for cash dispensers, post offices, baby parking areas, etc. Depending on the type of contract (property leases v business leases), the minimum guaranteed rental is increased by 75% or 100% of the ISTAT (Italian national statistical institute) index, unless otherwise specified in the analysed agreement.
- The existence of any **break options** granting tenants the right to early termination of the contract. The existence of early termination rights should be evaluated on a case-by-case basis. The valuer will decide whether to take into account, in the DCF, the possible exercise of the break option by the tenant based on the performance recorded by the latter. If the performance is poor or unsatisfactory, the tenant is more likely to exercise the right of contract termination as soon as possible.
- Term of the lease agreements. The lease agreements may provide for a mid-term expiration (for example 5 years, which can be automatically renewed for another 5-year term). As in the case of break options, for these contracts the situation should be evaluated on a case-by-case basis and, depending on the tenant's strength and characteristics, the owner will decide whether to keep the current tenant for the entire duration of the contract or allow it to withdraw at the first provided expiration date.
- Average residual duration of contracts. Depending on the specific cases, it may be interesting to determine the 'weighted average unexpired lease term' (WAULT) of contracts in effect at the date of valuation. This measurement expresses the residual period in which the income generated by the contract can be considered secure. This analysis can be accompanied by a diagram illustrating the amount of the minimum guaranteed rental that will be expiring in each individual year.
- The granting of possible incentives at the expiry of the contracts. In poorly-performing shopping centres, contract expirations could result in a possible reduction of the discounted cash flow. On expiry of the individual contracts it may be necessary to grant lower rentals, discounts, free rent periods, or financial support for the setting up of sales outlets to tenants already operating in the centre (whose contracts would therefore be renewed) or to new tenants. This risk should be taken into consideration in a valuation report, by introducing in the DCF potential rental reductions or costs to be incurred by the owner of the asset.

Vacancies/vacancy rate

The number of vacant units is a good indicator of the shopping centre's health.

The analysis should determine the number of units and the surface area they occupy, in terms of GLA, as well as the 'weight' of these units compared to the gallery as a whole. For each unit the analysis should review, whenever possible, the reasons of the vacancy, which may depend on:

- poor location of the unit in the gallery in terms of visibility
- size of shop window front, accessibility, etc.
- the size of the premises
- its layout, which may make the unit difficult to use for retail purposes
- the license situation, which may cause a unit to have an authorised sale surface area that is too small compared to the gross area of the store.

In most cases, a high vacancy rate indicates a state of poor performance of the entire shopping centre.

However, depending on the reasons of the vacancy, the following distinctions should be made:

- a vacancy rate that has been ongoing for a long time, which could be 'chronic' or 'structural' to the asset)
- a medium to long-term vacancy rate that can be considered 'strategic' when its objective is to allow a revision of the layout or an expansion of the gallery
- a vacancy rate that can be 'conjunctural', i.e. due to temporary economic difficulties experienced by the shopping centre.

From a valuation point of view, the units can be considered with different methods. The approach to be used varies from centre to centre, and should be carefully assessed according to the specific situation. If the vacancy rate is not chronic, it is possible to assign to each vacant unit,

within a DCF, a future lease date and a market rent, i.e. the assumption that these units will start generating income on a certain date. In some specific cases, the rates can be differentiated between vacant and rented units, so that the related risk can be assessed more accurately.

Revenues

In most cases, the contractual structure used in shopping centres provides for the tenant to pay a **minimum guaranteed rent** (**MGR**), or the annual amount of fixed rental, regardless of the tenant's sales revenues, and a **variable rent** (or **turnover rent**) component, which varies according to the tenant's sales revenues and performance. The two income components are by their nature characterised by different risk levels, and therefore should be treated differently for valuation purposes.

Minimum guaranteed rent (MGR) (see definition in subsection 2.2)

The amount is revalued annually on the basis of the ISTAT index variation. This amount is a relatively secure cash flow for the entire term of the contract. However, the minimum guaranteed rent may have a degree of risk that is more or less significant depending on the following elements:

- rent level (MGR/m^2), with respect to the reference market
- effort rate (see the definition below)
- tenant's covenant and financial soundness
- collection loss statement
- contractual guarantees in support of the rent
- contract term and presence of any termination clauses in the agreement
- unit's location within the centre (whether the unit is situated in a less visible position), its layout (whether it allows optimisation of the spaces and possible reuse) and its size.

Additionally, it should be pointed out that, at the time of contract renewal, and in general limited to the better performing *prime* centres, the amount of the fixed components (MGR) is generally increased when a new contract is signed. (The trend towards rises in the MGR when renewing the contract is typically cyclical and is linked to the time of renewal with respect to the general economic conditions.)

In a DCF model, the future inflation rates should be estimated in order to make a projection of the rent in the various cash flow years. The indicators to be taken as benchmarks are the official indicators published by ISTAT (FOI Index) and by Bank of Italy. Future forecasts can be made on the basis of international sources (OECD, European Central Bank, IMF and Economic Forecast) or by calculating the average inflation rates of the last 5 or 10 years.

Stepped rents

Rents progressively increasing over several years until the full-capacity rent is reached. The tenant pays a reduced rent during the early contract years (corresponding to business start-up), in order to maintain a sustainable MGR/turnover ratio while the tenant's business becomes stronger in terms of sales revenues. The stepped amounts are considered as MGR for the agreed period.

Extraordinary rent reductions and free rent

As with stepped rents, extraordinary reductions are deducted from the MGR. Free rent periods are deducted from the gross MGR.

Headline rent

The MGR expected at the end of the stepped rent or free rent periods. This is the highest rent level expected on the basis of the lease agreements existing at the date of the valuation.

Variable rent (or turnover rent)

Some lease agreements may include payment of a variable rent, which gives the owner the possibility of receiving from each tenant a supplementary rent in a percentage calculated on the basis of its turnover, excluding VAT. This variable rent is only applied if the annual turnover, multiplied by a certain percentage (to be agreed between the parties and formalised in a contract), is higher than the indexed minimum guaranteed rent. In this case, the amount exceeding the MGR constitutes the variable rent. Note that, over the duration of a DCF, any increase of the MGR may translate into a reduction, or in some case in an elimination of the turnover rent.

Specifically, the turnover rent – being linked to the sales revenues realised by the tenant – has a higher risk profile and could be subject to significant adjustments over the duration of the DCF. An approach that could be considered is to apply higher rates than those used for the 'fixed' rent component, in order to recognise the higher inherent risk of the income item.

In some cases, the contract may provide for payment of a variable rent only, proportional to the sales revenues. This type of contract involves a high degree of risk as the income is completely dependent on the tenant's performance. In this case, the valuer may consider, in the DCF, a progressive consolidation of a portion of the variable rent.

Market rent

At the end of each rent contract, and once appropriate renegotiation periods are considered, it is assumed that each contract will be renewed at market rent. The market rent is the value at which it is deemed that the asset under examination can be rented at the date of valuation. Market rent estimates generally take into account macroeconomic

factors, such as market trend, as well as more specific factors, e.g. location of the centre and of the unit within the centre, size of the unit, merchandise category, tenant's business performance, and analysis of the effort rate.

Other income

An existing shopping centre can usually generate additional sources of income besides the individual lease agreements of the gallery units. The most frequent sources of income include, among others:

- temporary lettings in the gallery (see the definition in subsection 2.2)
- lease of antennas
- photovoltaic systems
- advertising billboards
- lease of external areas (petrol stations, car wash)
- management of parking areas by third-party companies.

Since – similarly to turnover rent – these income components are characterised by high volatility and a high risk profile, it is necessary to analyse their contract duration (often one year or less) and their recurrence as well as the historic performance over the last 3/5 years. On this basis, it is possible to determine within a valuation whether to adopt a higher rate than that used for MGR capitalisation.

Multi-year performance trend

It is recommended to analyse the centre's performance trend over at least 2 years. Performance is considered like-for-like, net of VAT. This analysis should highlight the store's performance per square metre: this is an excellent indicator when compared to the benchmarks by type of label, merchandise category, store surface area, etc. Each tenant's sales trend should also be analysed, as well as the reasons that may have caused significant changes in sales revenues (declining sector, economic situation, increasing competition, specific difficulties experienced by the tenant, etc.).

Rent to sales ratio and effort rate

According to industry practice, to complete the analysis, valuers review the effort rate, i.e. the ratio between MGR (in case of stepped-rents, the headline rent should be taken into consideration) plus turnover rent and service charges and annual turnover, net of VAT, realised by individual tenants. This rate varies depending on unit size and merchandise category of the tenant.

The risk threshold, which is variable and specific for each distribution format/merchandise category, is the highest rent level sustainable by the tenant considering its turnover. When this threshold is exceeded, the business becomes non-performing and is at risk of default.

The rent to sales is calculated considering only the MGR and turnover rent v the tenant's turnover. The effort rate is calculated using the MGR, the turnover rent and service charges v turnover. It is useful in fact to add service charges to the MGR, as these are costs borne directly by the tenant and may affect the turnover significantly. An analysis of the effort rate is essential in determining the market rent to be applied upon expiration of the contract currently in force, at the time of valuation.

Latest lease transactions

It may be useful to analyse the latest lease transactions in the centre to be appraised. This analysis provides an understanding of tenant rotation, of how the MGR evolves in the specific centre, and whether or not a rent gain can still be obtained on the centre units. This analysis will underpin the choices made in terms of market rent estimate.

6 Costs

6.1 Non-recoverable costs

This section covers non-recoverable ordinary operating costs, and non-recoverable extraordinary operating costs, incurred by the asset.

This issue is handled by the owner/manager through in-house or external teams responsible for carrying out asset management activities covering the administrative and the technical components, from which the costs arise.

'Non-recoverable costs' means all the costs borne by the owner. They can be classified as follows.

6.1.1 Ordinary management

- IMU (Unified Municipal Tax or property tax): a tax within the Italian taxation system, applicable to the real property component of a taxpayer's estate. IMU is an annual amount payable on a half-yearly basis, generally paid by the owner.
- TASI (property tax): this tax came into effect in 2014. The amount is only partially paid by the landlord, as a percentage of the tax is charged to the tenant.
- Insurance: depending on the type of owner/manager, the policy may include additional insurance coverage over and above the standard coverage (e.g. against loss deriving from uncollected rentals during reconstruction of the property after a natural disaster/fire). As with the IMU tax, it is an annual amount usually paid by the owner.
- Administration and management costs (collection of rentals): typically expressed as a percentage of the gross annual minimum guaranteed rent (MGR).
- Variable rent administration and management costs: expressed as a percentage of the variable rent receivable per year.
- Temporary letting administration and management costs: typically expressed as a percentage of the amount of temporary lettings and/or flat-rate amounts.
- Contract registration tax: in accordance with Law no. 248 of 4 August 2006, a contract registration tax equal to 1% of the annual rent is applicable to lease agreements. This amount is treated as a percentage (0.5% payable by the owner) of the gross MGR. This generally applies to lease agreements, as in most business leases the entire cost is left for the tenant to pay.
- Reserve for outstanding receivables: this loss of revenues constitutes the potential loss of income deriving from unpaid receivables and pending disputes. It is expressed as a percentage of the gross annual MGR, and it is generally estimated by the valuer on the basis of information received on the tenants' unpaid rent situation.
- Vacant unit non-recoverable communal costs: the amount payable by the owner when a unit is vacant. It is calculated as a cost per square metre of gross leasable area per year.
- Agency fees (on new business leases and property leases): calculated as a percentage of market rent.
- Agency fees (on renewals of existing business leases and property leases): calculated as a percentage of market rent.
- Agency fees on temporary lettings.
- Loss of income (vacancy period): an amount assumed to represent months of uncollected rent, considering possible periods at discounted rent.
- Provision for extraordinary maintenance: a percentage of the gross annual MGR, or acquisition of a 3–5 year extraordinary maintenance plan.
- Structural vacancy rate: allowance to face chronic vacancy situations that may result from long-lasting non-occupation and/or from rent-free, possible stepped rents upon expiry of rental contracts and future void periods. Normally expressed as a % of the total gross rental revenue, which varies according to average vacancy rate throughout a significant period of time.

6.1.2 Extraordinary management

- Capital expenditures (capex): investments in the shopping centre made by the owner to improve performance. During a valuation, information on these expenditures is provided by the owner or manager.
- In some cases, if planned maintenance works are performed in the centre, the asset management team/company (if external to the owner's organisation) receives a fee for supervising/monitoring the works (watchdog fee) as a percentage of the extraordinary maintenance works.

6.2 Communal costs and recoverable costs (service charges)

These include all ordinary and extraordinary costs, such as those related to the maintenance of the gallery and outdoor areas, as well as administration and management costs, which are usually recoverable by charging a portion of the communal costs to each tenant. (This charge is generally stable and based on the table of asset portions, in thousandths, allocated to each unit [*Tabella Millesimale*].)

For some anchor tenants, such as some food anchors/ medium-sized units (MSUs), there may be communal cost cap agreements whereby the excess portion is taken over by the asset owner.

7 Market

The market context is a key section of a shopping centre valuation report, because it defines the economic and political environment that characterises the domestic and international situation at a certain valuation date. Market context addresses the fundamentals of a country's main indicators and ultimately seeks to provide recent comparable market transactions (both for the investment and occupier market) that can support all the necessary valuation assumptions and estimates to prepare a shopping centre valuation.

The more transparent and developed a country, the clearer and more practical is the market context that supports the determination of the market value of an asset.

The main aspects that a market context should cover are the following.

Economic outlook

- European and international
- domestic.

Political outlook (stability, reforms recently implemented, upcoming elections, etc.), consumer economy overview (retail fundamentals)

- GDP
- consumer prices
- unemployment
- consumer confidence
- retail sales (food and non-food).

Retail real estate market

Product:

- Retail GLA stock and growth year-on-year
- new developments and comparison to previous year
- comparison of the above with other European countries
- breakdown by region or macro areas (North, South, Centre, Islands).

Retailers and market rental values:

- New openings/retailers in the market
- retailer demand by type of scheme (prime v secondary) and by region
- average prime rental values (for average-size units) and comparison with previous year
- rental incentives.

Retail investment market:

- Retail investment volume year-on-year and semester-on-semester (domestic and at EU level)
- brief description of recent transactions, with specific focus on those retail investment deals that may be considered as comparable to the analysed asset (similar location, volume and type of deal) and that ideally should be benchmarked on the basis of a standard market practice, which should feature (in a developed and transparent market)
- investors' origin and characterisation
- investment trends
- prime shopping centre (gross and net) yields over the last 5/10 years.

Outlook:

- Consumer economy projections
- retailers' market
- investment market (investors focus and trends).

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