

Dissenting Report by Senator Nick Xenophon

Too Many Commercial Retail Tenants on a Short Lease

1.1 It is disappointing the committee failed to express a view on the majority of the matters explored during this inquiry. It is clear that many landlords and tenants, including representative organisations, favour a national coordinated approach and ultimately a single federal Act. As the states have not shown interest in harmonising their legislation, it is incumbent on the federal government to take a leadership role and incorporate the best practices from each state and develop model legislation. My views on Terms of Reference topics are as follows:

The first right of refusal for tenants to renew their lease

1.2 Preferential rights provisions are designed to address the power imbalance between landlords and tenants, which in the case of smaller retailers can be significant. In South Australia and the Australian Capital Territory, preferential rights are provided for in the relevant retail leasing acts; however, these statutory provisions do not necessarily translate into effective protection for tenants. For example, the South Australia legislation allows landlords to go to the market to obtain alternate offers from retailers who would use the premises for different purposes than the sitting tenant. The prospective tenant may be able to afford a higher level of rent than the sitting tenant (who has no ability to match this rental). SA Lease Management's (SALM) submission gave an example of how South Australia's legislation can fail to protect existing tenants:

An interesting example of this situation arose in a small shopping centre in Glenelg where the sitting tenant was a chocolatier who ended up competing against a yiros operator who was able to trade much longer hours, achieve a higher level of turnover and pay a higher level of rent than the chocolatier could afford to pay. The chocolatier was given the option of either changing their business or vacating - they vacated.¹

1.3 The Jewellers Association of Australia also expressed concerns that in the case of jewellery stores, landlords are refusing to acknowledge reductions in market rent when leases expire and instead prefer to keep tenants on monthly leases with high rents rather than negotiate a long term lease reflective of current market rental rates.²

1.4 In order to address these concerns, SALM has made a number of suggestions. Firstly, retail leasing legislation in each state could be amended to reflect provisions that currently exist in Tasmania's Fair Trading (Code of Practice for Retail Tenancies) Regulations 1998 that contain:

The general principle... that once landlords and tenants agree that an existing lease will be renewed both landlord and tenant have to either

1 SA Lease Management, *Submission 3*, p. 3.

2 Jewellers Association of Australia, *Submission 6*, pp. 2-3.

negotiate terms of a new lease which both accept or if agreement cannot be reached then the rent is set by an independent expert valuer and both parties are bound by the valuer's rental determination.³

1.5 In response to questions put on notice during the committee's public hearing, SALM proposed an alternative solution to the issues tenants face when negotiating lease renewals, particularly those tenants who have invested significant funds into shop fit-outs and refurbishment:

Rather than have first rights of refusal, an alternative is for every retailer who is required to fit-out a shop in accordance with the landlord requirements, is offered a ten year lease term with various options -

- The tenant will have the option of terminating the lease at any time without penalty after first giving a minimum of say, 3 months' notice.
- The tenant to have the right of implementing a market review of rent twice during the term of the lease with the option of terminating in the event of the market rent being determined at a rent greater than the retailer can afford. There would be other criteria attached to the market review dates including not earlier than say 12 months after lease commencement and at least 3 years apart.
- The landlord to have the right to implement a market review of rent twice during the term of the lease subject to the same criteria as imposed on the tenant.
- The rights of early termination would only be taken up by the tenant if their business is failing and in full recognition of the cost of closing the business, reinstating the premises to bare shell and forfeiting the tenant's investment in the fit-out (other than what can be salvaged and installed elsewhere.⁴

1.6 The ability to call for a market valuation of rents would have benefited one retailer mentioned in SALM's submission. Their client owned a successful café business with an annual turnover of approximately \$2 million per year. Turnover had increased by about 10 percent over the past three years and the business was making an annual profit (after wages) of about \$70,000. However:

Westfield decided it was time to expand the centre and introduced another café business into the centre at a much lesser rental rate per square metre and with a substantial capital contribution to assist in the cost of their fitout. The new business took customers from the existing café business and reduced its turnover from \$2,300,000 to \$1,800,000 (forecast to reduce to \$1,750,000). Our client is stuck with a current high rate of rent but in the meantime will lose between \$80,000 and \$100,000 in the next 12 months. There is no requirement in the current legislation for the landlord to remedy this.⁵

3 SA Lease Management, *Submission 3*, p. 2.

4 SA Lease Management, *answers to questions on notice no. 4*, p. 2.

5 SA Lease Management, *Submission 3*, p. 4.

1.7 Given the dramatic change in operating conditions, a tenant should be entitled to call for a market rent review. Similarly, situations may arise whereby a landlord may require a market review of rents; for example, if a landlord has made improvements to the property resulting in more customers and higher sales.⁶

1.8 My view is that the three options proposed above should be explored as they would best serve both retailers and landlords, as they provide a fair option for businesses that may experience hardship and recognise the financial investment retailers and landlords have in their respective businesses.

1.9 Such reforms could be combined with the national adoption of provisions within the Tasmanian Fair Trading (Code of Practice for Retail Tenancies) Regulations 1998 as they relate to lease renewals. Preferential renewal rights in all other states and territories do not take into account the current use of the site. However, in Tasmania, if a landlord offers renewal rights to a sitting tenant (who agrees to renew) and agreement on the commencing rent for the renewed term cannot be agreed, rent is set by an independent valuer who will determine the level of rent to be paid using the universally applied definition of market rent which takes into account the permitted use definition on the lease. If the tenant considers the determined rent to be too high the tenant still has the option of not proceeding with the renewal of the lease.⁷

Recommendation 1

1.10 That rights of renewal be enshrined on a national basis, using the Tasmanian Fair Trading (Code of Practice for Retail Tenancies) Regulations 1998 as a template.

Affordable, effective and timely dispute resolution processes

1.11 The cost to tenants of enforcing rights or challenging representations made by landlords in court is currently prohibitive for the majority of small businesses. For example, it is highly unlikely a small business will risk many tens of thousands of dollars pursuing a misrepresentation action against a landlord in court even if legal advice indicates they have a reasonably strong case.⁸

1.12 In its majority report, the committee acknowledged the importance of the dispute resolution role played by Small Business Commissioner offices around Australia. Statistics provided to the committee by the Shopping Centre Council of Australia (SCCA) demonstrated the successes of some of these offices, including in New South Wales where 94 percent of all matters referred for mediation are resolved without proceeding to court for a decision.⁹

6 SA Lease Management, *Submission 3*, p. 4.

7 SA Lease Management, *Submission 3*, p. 4.

8 Mr Brian Scarborough, *Committee Hansard*, 13 February 2015, p. 15.

9 SCCA, *answers to questions on notice no. 2*, p. 11.

1.13 The committee has recommended that where possible the Federal Government should give recognition to and where ever possible support the role of small business commissioners. While it is encouraging to see the committee's favourable view of small business commissioners, I would like to see a firmer commitment to Federal Government support for these roles; for example, by way of an industry code of conduct managed by the Australian Competition and Consumer Commission.

Recommendation 2

1.14 An industry code of conduct in respect of fair, effective, and cost efficient dispute resolution be implemented, to be managed by the ACCC.

A fair form of rent adjustment

1.15 Most rent reviews were based on CPI plus a set percentage. Whichever calculation method is used, it is always detailed in the originating lease. However, as detailed by SA Lease Management and Mr Bensimon, the rental at the finalisation of the lease term is often excessive for long-term sitting tenants. Some landlords are capitalising on the fact that the retailer has built their business up over many years and will not vacate, no matter how high a new rental is. There is also evidence to suggest that retailers new to a shopping centre are being offered significant rental discounts and incentives, which are in effect being offset by the higher rent imposed on sitting tenants.

1.16 Concerns were raised with the committee that increases in rental rates were far surpassing growth in turnover:

In the past when the Australian economy has grown significantly and retail sales have performed well, annual rent increases of up to 5% have been accepted as an affordable impost of entering into new leases to occupy prime locations in shopping centres.

Over the past five years this situation has changed and growth in shopping centre turnover, retail sales and customer traffic has remained virtually flat and has not kept pace with movement in the Consumer Price Index. Over the past five years CPI has grown by about 10% on a cumulative basis, and rent has increased by between 15% and 20% over the same period.¹⁰

1.17 SALM confirmed these concerns in its submission, telling the committee that a conversation with a landlord of a major shopping centre revealed that 'they can only achieve growth equal to CPI by maximising rental growth from sitting tenants to offset rent reductions for new tenants.'¹¹

1.18 Based on these experiences, it is clear sitting tenants are often vulnerable to rent increases that do not necessarily reflect the profitability of their businesses. Together with factors such as large initial fit-out costs (discussed later in this report), tenants can become hamstrung when they must decide whether to stay on in their

10 Jewellers Association of Australia, *Submission 6*, p. 4.

11 SA Lease Management, *Submission 3*, p. 5.

current location in order to write-off fit-out costs or try to find a new location. As Mr Polkington pointed out:

The problems of a small family shop is that the shop is their job, it is their superannuation and it is their life, and they cannot afford to lose it. They are in a very much weaker position when it comes to negotiating all of those things.¹²

1.19 SALM has proposed that ratchet clauses (a clause that operates to prevent rent decreases when rent rates are reviewed) should be excluded from all leases. Ratchet clauses are particularly harmful where rent may have increased to an amount which then takes the lease outside of the protection of retail leasing legislation (see below). As SALM explains:

The leases are now outside of the Act and although market rent may be less than \$400,000, because the lease includes a ratchet mechanism, the rent cannot be less in the event of market review. The lease is never brought back under the Act as the ratchet clause is activated.¹³

Recommendation 3

1.20 Ratchet clauses be excluded from retail leases, unless expressly agreed to by the tenant.

Implications of statutory rent thresholds

1.21 Statutory rent thresholds are intended to provide some protection to smaller tenants through provisions contained in retail tenancy legislation. The Shopping Centre Council of Australia and the Australian National Retailers Association argued that larger retailers are 'capable of looking after themselves in negotiations with landlords'¹⁴ and that any national harmonised approach to retail leasing 'should exclude large retailers and instead focus on the relationship between smaller retailers and landlords as this is the area where market failure is most likely to occur'.¹⁵

1.22 In South Australia, it is possible for a lease to come under the Retail and Commercial Leases Act 1995 at its commencement, but should rent exceed \$400,000 per annum the lease is then excluded from the Act. SALM explained the consequences of this:

In South Australia we have the situation whereby a lease can be under the Act when it commences and then as a result of rent reviews becomes outside of the Act during the term of the lease. This occurs even though the type of business has not changed nor have the proprietors. Typically turnover has not grown, the number of employees has not grown, and the type of products sold has not changed, however, as a result of legislation the business is now redefined as big business and outside the protection of

12 Mr Polkington, *Committee Hansard*, 13 February 2015, p. 20.

13 SA Lease Management, *answers to questions on notice no. 4*, p. 4.

14 SCCA, *answers to questions on notice no. 2*, p. 10.

15 ANRA, *Submission 20*, p. 1.

the Act. This means that at the time of lease renewal, the tenant is no longer protected by Preferential Rights and if there is a right of renewal the landlord no longer has to follow the rules which would otherwise apply.¹⁶

Recommendation 4

1.23 Whatever the terms of the lease are at the time it is entered into ought to continue for the full term of the lease, unless explicitly agreed to otherwise.

Bank guarantees

1.24 Bank guarantees can be a necessary form of security for landlords in the event that lease terms are broken by a tenant.¹⁷ However, concerns were raised with the committee regarding the amount some landlords are demanding as security, which has 'the effect of reducing the amount of working capital available to tenants in addition to costing between 2% and 4% per annum in bank fees'.¹⁸ The Jewellers Association of Australia estimated that between \$1 and \$2 billion could be tied up in bank guarantees in the retail sector.¹⁹

1.25 Concerns were also raised in relation to when bank guarantees can be drawn down by a landlord. The Restaurant and Catering Industry Association suggested that retail leasing legislation should 'be explicit about when bank guarantees can be drawn down, including the requirements for informing tenants when this has occurred'.²⁰

1.26 Tenants may find themselves in a difficult position where they have agreed to pay a high level of rent but can no longer afford to do so. A landlord may also struggle to find another tenant who will agree to pay the same level of rent while running a similar business to the sitting tenant. The landlord may then draw down on the entire bank guarantee, putting the tenant at risk of financial ruin, particularly if they have given a personal guarantee.²¹

1.27 I support SALM's proposal that:

A better way of imposing bank guarantees on tenants is to limit the bank guarantees to 28 days in the same way as security deposits are limited and restrict them to apply only to the fair market rental value of the tenancy, not the super rent being paid by a tenant which may never be paid by another.²²

Recommendation 5

1.28 Bank guarantees on tenants be limited to 28 days.

16 SA Lease Management, *Submission 3*, p. 5.

17 SCCA, *Submission 17*, p. 19.

18 Jewellers Association of Australia, *Submission 6*, p. 5.

19 Mr Polkington, *Committee Hansard*, 13 February 2015, p. 19.

20 Restaurant and Catering Industry Association, *Submission 2*, p. 3.

21 SA Lease Management, *Submission 3*, p. 6.

22 SA Lease Management, *Submission 3*, p. 6.

A need for a national lease register and full disclosure of incentives

1.29 Responses to this particular term of reference were mixed as views hinged on what information should be included in such a register. At the outset it is important to emphasise the rationale behind a national lease register; namely to address the information asymmetry that currently exists between tenants and landlords.

1.30 Leasing Information Services described this information asymmetry in more detail, as well as its consequences:

Information asymmetry within the retail leasing market is a serious economic issue which leads to price distortions due to the fact that one party possesses more or better information than the other. This creates an imbalance of power in transactions which leads to inefficiency and in the worst case scenario, market failure.

Although our aim as a business is to simply empower all participants within the retail market, favouring neither tenants nor landlords, our experience has shown that it is generally the tenants who lack key information to make informed and enabling decisions. Often left in the dark with a limited number of comparables, great burden is put on tenants within an already competitive industry to secure the optimal rent.²³

1.31 While lease registers do already exist in some states, SALM was of the view that they:

...are of little benefit to most retailers in negotiating their leases. They are not searchable to provide a mechanism for sorting the data into location, tenancy type, shop area, retail type, date commenced, method of rent review, etc. The data is expensive to purchase and impossible to interpret by anyone other than an expert.²⁴

1.32 The effect of this lack of transparency was described by Mr Scarborough at the committee's public hearing in February:

I was sitting on a board meeting of a group that I was representing, talking around the table about market rents and how information on what rents are being paid is shared between various members. One question was asked of a party who had just finished negotiating a lease as to what level of rent they were paying. They said between \$2,000 and \$2,100 per square metre. They said that seems relatively expensive and asked if there was an incentive involved. There was a very large incentive. It was about \$150,000. We said, 'If we had not asked you that question and you were not required to give that out, we would be believing that the market rent was in the range of \$2,000 to \$2,100 when it is actually not.' The incentive of \$150,000 offset the cost of the fit-out enormously; instead of having to fund a \$200,000 fit-out over five years, they only have to fund \$50,000. Amortising at seven or eight per cent—I am not going to do the math, but

23 Leasing Information Services, *Submission 8*, pp. 4-5.

24 SA Lease Management, *Submission 3*, p. 6.

let's keep it simple—it changes dramatically the actual market value of the rent.²⁵

1.33 The Jewellers Association of Australia also provided the example of rent free periods distorting market rent values and the potential risks involved in relying on data supplied in some current registers:

Mr Pocklington: ...One of the concerns we have is: let's say that there is a lease for \$100,000 and the landlord says, 'Let's make it \$120,000 but we'll give you a few months rent free.' The net result for that tenant is the same, but the supposed market value is revalued by 20 per cent. I think that is a concern on the retailers that, when looking at lease figures, maybe are not the real market figure.

Mr Bensimon: I would agree and just want to add that it also misleads. The government is providing that data on the lease registers in New South Wales and Queensland and is therefore providing inaccurate information to the market as it is government-provided data.²⁶

1.34 Lease transparency is also important for financiers, who typically rely on valuations that are based on the full lease value. Unreported incentives potentially over-value the property, which may be mortgaged or provided as some other form of security.

1.35 I strongly support SALM's proposal that landlords could complete a standard form setting out the 'all the commercial terms in a tenancy schedule format which could be electronically registered'.²⁷

Recommendation 6

1.36 An organisation such as the Australian Property Institute (Valuation Division), in consultation with tenant and landlord stakeholders, should develop a standard form to be completed by landlords when entering into a lease. This form should require the disclosure of the commercial terms of the contract, including all incentives offered to the tenant.

Provision of sales results

1.37 Unsurprisingly, organisations representing tenants expressed reservations about the provision of sales results, particularly in the context of these results being used in rent negotiations.

1.38 In its submission, the Restaurant and Catering Industry Association stated:

Turnover data is an area of considerable contention for restaurant owners. The ability of landlords to request turnover data and make decisions based on this information results in inequity for operators in the decision making process. There is no transparency in how this information is used across

25 *Committee Hansard*, 13 February 2015, pp. 16-17.

26 *Committee Hansard*, 13 February 2015, p. 20.

27 SA Lease Management, *answers to questions on notice no. 4*, p. 3.

multiple tenant arrangements, particularly in shopping centres. Rarely do landlords grant struggling tenants rent concessions following a review of turnover data, yet rents are revised upwards based on favourable earnings recorded.²⁸

1.39 SALM told the committee:

Most leases in shopping centres require tenants to give monthly reports on sales for the previous month. This is done on the premise that it allows landlords to gauge the performance of the centre and adjust advertising/promotion/tenancy mix to achieve the best retailing atmosphere for the benefit of their tenants. This may be the reason given by landlords but the underlying reason is to ensure they maximise the amount of rent their tenants can pay and determine the degree to which they will want to renew leases rather than vacate. If a tenant has a successful business, their sales levels will be high and flagged to the landlord via monthly sales reports. The tenant will be disinclined to give up that business and vacate the tenancy and will agree to a much higher rent than would otherwise be required to secure the space in the event of it being vacated and a new deal negotiated.²⁹

1.40 There are currently discussions surrounding a code of practice governing (amongst other things) the provision of sales information being conducted between the Shopping Centre Council of Australia, the National Retail Association, the Australian Retailers Association and the Pharmacy Guild.³⁰

1.41 Mr Michael Lonie of the National Retail Association hinted there was some frustration as to the progress of these discussions, telling the committee

...we thought that we were moving towards obtaining a code of conduct between landlords and the various retail associations, we were only to find that a couple of the retailer associations had gone back to their board and could not agree with what was going on. Whereas, we were more than happy to move forward in having a code that gave greater disclosure of what the turnovers were that related to various centres.³¹

1.42 A meeting is being arranged between the Australian Retailers Association and its members to discuss the terms of this draft code in more detail.

1.43 Consideration should be given to a system whereby tenants provide information as to the general movements of sales such as whether they have increased or decreased in the past month, but not the actual amount of increase or decrease. This type of index would provide a guide to landlords as to the performance of their centres, whether promotional activities have been effective and whether they have achieved the right mix of tenancies. Specific turnover figures would no longer need to

28 Restaurant and Catering Industry Association, *Submission 2*, p. 3.

29 SA Lease Management, *Submission 3*, p. 7.

30 SCCA, *Submission 17*, p. 26.

31 *Committee Hansard*, 13 February 2015, p. 3.

be supplied by tenants, putting at rest concerns about the inappropriate use of such data in rent negotiations.

Recommendation 7

1.44 A code of practice that incorporates the broad reporting of sales and occupancy costs in Australian shopping centres be finalised and implemented as soon as practicable. Such a code should prohibit specific commercial-in-confidence sales and occupancy data being provided to landlords.

Contractual obligations relating to store fit-outs and refits

1.45 The ability of a tenant to ameliorate the cost of a store fit-out and refit over the life of a lease is an essential component when negotiating lease terms and renewals. A typical store fit-out for a 100m square metre store is approximately \$200,000 to \$300,000. As SALM explained:

Where a lease term is five years, the cost of the fit-out must be written off over the five year term. If the fit-out costs \$250,000 and the interest is 8% the annual expense to the retailer is approximately \$60,000.³²

1.46 While on the face of it leases with longer terms may be more attractive to tenants as they allow the cost of a fit-out to be written off over a longer period of time, this is not necessarily the best scenario for tenants. Mr Scarborough suggested to the committee that they key was negotiating a more secure and fair method for how a lease is dealt with when it reaches the end of its term, including rights of renewal and the ability to obtain an independent valuation of market rents at that time.³³ Shorter lease terms also protect tenants from being trapped in an arrangement that they cannot afford.

1.47 The ability to negotiate fair lease renewal terms in the face of high fit-out costs and high rents was explained by Mr Bensimon at the committee's public hearing:

Mr Bensimon:...one example is our Myer Centre store, that we had in Adelaide City. We really had to be prepared to walk away—we had a \$350,000 shop-fit on that—and the rent was at a level that was so high to our turnover ratio that we had to bail out. We have other stores to be able to pick up the slack, so it was not the end of our business. But were that to be our only store, it would have been a devastating day for us. When we handed in that letter saying we would vacate, our rent was dropped by 40 per cent. So it shows that there was a huge buffer that these people were prepared to let us suffer through before they would allow us to lower that rent, and it is an example of what happens out there.³⁴

Recommendation 8

1.48 The cost of fit-outs ought to be a factor in determining the length of the lease.

32 SA Lease Management, *Submission 3*, p. 7.

33 *Committee Hansard*, 13 February 2015, p. 16.

34 *Committee Hansard*, 13 February 2015, p. 20.

Conclusion

1.49 A common theme addressed throughout this inquiry is that retail leasing has been the subject of numerous inquiries, both at a federal and state/territory level. Despite these reviews, it seems little has changed in the industry. Ms McPhee, the Chief Executive Officer of the Australian National Retailers Association summarised the frustration felt by many in the industry:

I think the challenge is a number of these issues have been prosecuted in numerous inquiries and reviews over many years. Recommendations to support changes have been made, yet change has not been forthcoming quickly.³⁵

1.50 Meaningful reform is urgently needed. Greater transparency is required in terms of incentives offered by landlords to tenants, particularly if they have the effect of distorting market rents. A comprehensive package of reforms, as recommended above, while initially resisted by some landlords, should have the effect of giving more small businesses the confidence to enter into long term leasing arrangements because such reasonable protections are afforded. This could only stimulate the commercial retail leasing market.

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35 Ms McPhee, *Committee Hansard*, 13 February 2015, p. 3.

