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Committee Secretariat
Senate Standing Committees on Economics
PO Box 6100
Parliament House
CANBERRA ACT 2600

By email: economics.sen@aph.gov.au

Dear Members of The Senate

NATIONAL APPROACH TO RETAIL LEASING ARRANGEMENTS

We enclose our submission which addresses the various issues outlined in the Terms of Reference.

South Australian Lease Management was established over 20 years ago to assist retailers in the negotiation and management of their leases. We have many thousands of clients scattered around Australia ranging from individual mum and dad retailers to large national corporations.

We invite you to view our website: www.saleaseman.com.au

The recommendations made in our submission have developed as a result of our many and varied experiences in negotiating leases, dealing with disputes, establishing market rent and many discussions with lawyers, accountants, landlords, architects, shopfit designers and developers.

We will be pleased to meet with any of the members of the Committee dealing with this issue to answer questions concerning our submission, expand on matters which are of interest to them and give concrete examples of the situations we have been involved in which have led us to our recommendations.

Yours faithfully

Brian C Scarborough
Certified Property Practitioner
Certified Practising Valuer
Dip. Tech. (Val.) F.A.P.I.

*Enc
Submission*



Submission

to

Senate Standing Committee on Economics

in reference to

National Approach to Retail Leasing Arrangements

Prepared By
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15 August 2014



The Need for A National Approach to Retail Leasing Arrangements to Create a Fairer System and Reduce the Burden on Small to Medium Businesses and Associated Benefits to Landlords

For the past five years (at least) gross rent paid by retailers in Australian shopping centres has increased at a much greater rate than the main performance indicators of shopping centres.

Specialty Shop Moving Annual Turnover per Square Metre

This is a measure of the amount spent by customers in shopping centres on goods sold by speciality shops. Moving annual turnover is used to eliminate month on month variables as it is counted by measuring the turnover in the current month plus the previous eleven months. It is analysed to a dollar amount per square metre of speciality shop retail space to provide a comparable measurement when measuring the performance of different centres.

Customer Traffic

This measures the total annual traffic flow of customers through the shopping centre.

The attached table provides data on the moving annual turnover per square metre for specialty shops and customer traffic in most Westfield centres in Australia. The data provided by Westfield should be reliable and accurate.

We have only included data from centres which have reported information in 2008 and 2013 to ensure absolute comparability. The method of measuring specialty shop turnover also ensures comparability as it automatically takes into account any expansion or contraction of the individual centres during the five year timeframe.

In summary, the figures show that on average Westfield centres increased specialty shop turnover per square metre by 2% from 2008 to 2013 (this is not an annual amount, it is an absolute increase). By contrast the Consumer Price Index increased by 10% for all capitals over the same period and Westfield rents increased by 20%.

Over the past five years, as indicated in the table, retailers have paid an increasing percentage of their net profit to landlords to cover the disproportionate increase in rental growth over turnover growth. If their businesses have not been profitable, the imbalance between growth in turnover and growth in rent has caused retailers to fund the increase in rent by increasing their level of debt or reducing the value of their own assets.

Growth in the capital value of landlord's assets occurs at the expense of their tenants and is the driving force behind all lease negotiations.

When leases with new tenants are entered into, market forces generally prevail and provided the retailer is savvy enough to pay only a rent which the market and their proposed business can support and generate an adequate level of profit, then the rent deal struck will be fair and reasonable.

Landlords and their agents have particular ways in which rent can be leveraged up beyond the amount which a retailer can actually afford to pay by providing incentives (capital contribution or rent free periods) which have the affect of reducing the cost of borrowings for the retailer to install their shop fitout but is achieved at the expense of the retailer's commitment to a much higher level of rent for the whole of the term of the lease.

Existing retailers who wish to remain in the retail premises they have occupied and operated successful businesses are in a much worse position when it comes to negotiating a fair outcome for a renewal of their lease. They generally have a significant outstanding debt to their bank as a result of their commitment to an expensive fitout (demanded by the landlord to maintain a certain standard of presentation in their shopping centres). This maintains the illusion of improved capital value of the centre if all retailers have invested heavily in their fitouts. Retailers in this position are generally faced with the prospect of either realising an expensive loss (in the value of their fitout) if they do not renew the lease or if they do renew the lease are forced to pay a much higher rent than would otherwise be the case.

This situation is most obviously apparent when shopping centres are expanded and leases negotiated with new tenants for new space created.

The new leases are invariably at much discounted rates per square metre to entice new retailers to lease space in the expanded centre. Large fitout contributions are made available as a result of funding arrangements put in place for the development project and all of this occurs at the expense of sitting tenants who are paying existing levels of high rent at a time when their businesses are most vulnerable.

Various Retail and Commercial Leases Acts exist around Australia with the primary function of protecting the interest of tenants. The legislation generally fails in that regard.

First Right of Refusal for Tenants to Renew Their Lease

This legislation exists in several states but the only one which has got it partly right is the Tasmanian Act. The general principle is that once landlords and tenants agree that an existing lease will be renewed both landlord and tenant have to either 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. This system resolves the problems which occur elsewhere. For example, in South Australia, the landlord is obliged to give the sitting tenant Preferential Rights for the negotiation of a new lease in their existing premises however there are many ways in which the legislation is defeated.

If the sitting tenant is already paying more than market rent, the landlord is under no obligation to reduce the rent or even enter into negotiations for a new lease. In that case the sitting tenant holds over under the terms of the old lease as a monthly tenant, without the security of a new long term lease even though the tenant has Preferential Rights. That right has to be triggered by the landlord offering the tenancy first to the sitting tenant at a rent which the landlord is prepared to accept. If that rent is above market the tenant will most likely not accept it and in that case the landlord should put it to the market to establish its level of market rent. If the market rent is substantially less than the asking rent the landlord will receive no offer for it and is therefore under no obligation to present an offer to the tenant which the landlord would otherwise accept from a third party. The tenant is then stuck on a monthly tenancy waiting for the landlord to accept the market rent.

The other problem with the South Australian legislation is the landlord is not required to go to the market and obtain alternate offers from new retailers who are prepared to occupy the space and trade the same use as the sitting retailer. A shoe retailer might occupy a prime spot in a shopping centre and is not prepared to pay the rent which the landlord is asking. The landlord can go to the market and accept a lease offer from any other retailer with a use for that shop which can pay a greater rent per square metre as a result of the type of business they wish to operate from the shop. The sitting tenant has no chance of matching that deal. (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.

In Tasmania this situation would not occur as once an agreement is reached, the lease will be renewed and a valuer will determine the level of rent to be paid by that retailer for that shop taking into account the permitted use defined in the lease which is the existing retailer's current use.

In other words Preferential Rights only works if the existing use is maintained when the premises are offered to the market at large and the rent paid for the space is a rent which that existing use can afford to pay (this conforms with the standard definition of market rent which an independent determining valuer will follow).

Dispute Resolution

Disputes in lease contracts between landlords and tenants generally only occur due to ambiguous legislation which results in different interpretations of the legislation. If however it is clear that one party has, as a result of their action or inaction caused a loss to the other party, then an affordable, effective and timely dispute resolution process is required. It cannot be a process which allows one party to "deep pocket" the other as that just means the party with the most money wins. An example where a dispute mechanism is required occurs when a shopping centre is expanded and the landlord decides that existing uses can be replicated without taking into account the potential damage it can cause to the business of an existing tenant.

This recently occurred to a client of ours in West Lakes Shopping Centre where their successful cafe business has operated for many years. It was purchased by our client 4 years ago with a turnover of about \$2,000,000. They have increased it to approximately \$2,300,000 over the past 3 years and it was generating a net profit after all wages of about \$70,000 per annum. Westfield decided it was time to expand the centre and introduced another cafe 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 cafe 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.

The legislation should be changed to require the action of landlords to be subject to independent review whereby rent would be adjusted automatically (triggered by the landlord or the tenant) in the event of changed circumstances to the detriment or benefit of the other.

If this is the case, landlords will be more cautious before introducing competitors if they know there will be an adjustment in rent paid by sitting tenants who are adversely affected by their decision.

This situation is covered by retailers who have sufficient strength to negotiate specific terms into leases. For example service station operators include in their leases the ability to terminate if traffic conditions change so as to affect the profitability of their business. If an effective dispute mechanism process is included in legislation, it should result in an automatic, cost effective, and efficient process so that all parties to the contract know it is available to them and will be enacted as a consequence of either parties' action or inaction.

Rent Reviews

The method of reviewing rent is one of the major commercial terms in a lease. The methodology is highly variable dependent upon the deal that has been negotiated and, provided all parties understand the implications of the review process and it is taken into account when the commencing rent is agreed, the method of review (provided it is not open to interpretation or selection by only one of the parties to the contract) should be fair.

For example, if a commencing rent is agreed to be exceptionally low on the basis that both landlord and tenant understand there is substantial risk involved in establishing a business and the lease has a method of rent review which allows rent to increase if the business succeeds, that is a fair rent review process.

Most of the large landlords groups i.e. Westfield, AMP, Lendlease, Colonial First State etc have set formulas for rent reviews which will not be varied in a lease negotiation. Provided everyone knows that is the position, the commencing rent should be negotiated to take into account the rent review process. At present, Westfield reviews rent by CPI for All Capitals + 2%.

This creates a degree of contrived growth in both rental return and capital value but, as is happening now when new leases are negotiated, there is often a substantial reduction in the commencing rent to ensure the increased rent in the following 4 to 5 years remains affordable. This process does not work when old leases are renewed as "Preferential Rights" does not work unless you are in Tasmania. In all other states, unless the tenant is prepared to call the landlord's bluff and vacate the tenancy they will inevitably pay a higher rent than market level.

In a candid conversation we have had with one major shopping centre landlord they acknowledged they can only achieve growth equal to CPI by maximising rental growth from sitting tenants to offset rent reductions for new tenants.

The Statutory Rent Thresholds

The Retail and Commercial Lease Legislation around Australia endeavours to protect only those tenants that require protection by imposing an upper limit on rent before the lease is considered to be outside of the Act. When a lease is under the Act there are many benefits for the tenant but in particular the method of rent review is restricted from being "greater of one method or another". It usually also prevents the landlord from passing on the cost of land tax to their tenants. 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 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. The market rent review which is unrestricted under the Act can include a ratchet clause which prevents the rent from being less than it was prior to the lease renewal. This means that even though the market rent might be less than currently paid, because the lease is outside the Act, the rent cannot be reduced and the lease remains outside the Act even though it should now be under it.

The best way of solving this problem is to legislate so as to ensure that any lease negotiated under the Act remains under the Act for the term of the lease and its renewals (or the threshold level increases at the same rate as rent is increased by the rent review process).

Bank Guarantees

Many landlords are under the mistaken belief that provision of a bank guarantee has little impact on a tenant's business as it is simply a letter given to the landlord by the tenant's bank. Nothing could be further from the truth. Banks will only provide bank guarantees if the amount for which the bank guarantee is written is supported by security provided by the tenant (their customer). For example a \$50,000 bank guarantee provided by a bank must be supported by either by \$50,000 cash deposit or a reduction in the tenant's overdraft account by \$50,000 or by provision of a \$50,000 mortgage over equities owned by the tenant. This has the affect of removing available capital from the tenant's business which can be a severely limiting factor for any business which requires capital during the course of its operation to upgrade, promote, purchase new stock or just to cover poor periods of trade.

In addition to taking away available capital from the tenant's business it also has the affect of costing the tenant between 2% and 4% of the amount of the bank guarantee – the amount charged by the bank to service that bank guarantee.

The provision of bank guarantees has been partly legislated against in South Australia where it was thought that a bank guarantee would be considered the same as a security deposit. Security deposits are meant to be lodged with the Commercial Tribunal and held by the Government as security against the tenant defaulting. Security deposits are equal to the value of 28 days rent. Unfortunately this legislation does not specifically include bank guarantees in the reference to security deposit and lawyers advising landlords have determined that because a bank guarantee is not money, it is a letter from a bank, it is not caught by the legislation. Landlords are therefore increasing the level of bank guarantees required from tenants to (in most cases) a minimum of 3 months to as much as 12 months.

The additional problem of bank guarantees is they give landlords immediate access to cash in the event that a sitting tenant is unable to pay the level of rent they have agreed to pay. If the tenant has negotiated poorly and is paying greater than market rent for the space occupied, or if they are a unique business which can afford to pay a higher level of rent, the tenant is the one most at risk if they cannot continue to pay that high level of rent. The landlord, in not receiving that high level of rent, will receive rent from another tenant that can pay the market level of rent, not the artificially high level of rent. This places the sitting tenant who has agreed to pay the high level of rent in a worst case position. If they default, the landlord will find it very difficult to replace that cashflow as there may be no other tenant prepared to run the same type of business or accept the same level of risk as the sitting tenant. Under these circumstances the tenant loses the whole of the bank guarantee and risks personal ruin if they have given personal guarantees for the performance of the lease.

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.

National Lease Registers

There are already lease registers operating in several states in Australia but these 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. If all leases are registered and available to the public at little cost to search, there would be much misunderstanding as to the level of market rental and frustrated negotiations. Retailers generally misunderstand the concept of different levels of rent for different retailer types in different locations and the purpose for which they have been included in the landlord's mix of retailers in a shopping centre precinct. Lease registers in their current format do not include full disclosure of incentives, fitout contributions and rent free periods.

Without access to that information new tenants can be persuaded to accept deals which would otherwise never be accepted on the open market as the information used to establish market rent level has not included disclosure of all aspects of the deal which they are using as evidence of market rent and the basis for their negotiation.

Full Disclosure of Incentives

It should be illegal for incentives to be hidden from public view to deceive the market and everyone involved in it. At present, when retail and commercial properties are valued to support applications for finance or for the benefit of shareholders, valuers are typically given a schedule of leases on which to base the market valuation. If that schedule does not include the incentives provided to tenants to commit to the levels of rent shown on the schedule, the value they have put on the property will be greater than its market value. The only way actual rent paid can be calculated for the purpose of giving evidence is to determine the net present value of the benefit of the incentive and amortise that as a reduction against rent paid for the term of the lease.

Monthly Sales Figures

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.

It would be equally beneficial for landlords for tenants to give an indicator of movement in sales rather than absolute figures. This would also prevent landlords from “inadvertently” giving away vital information on the businesses of sitting tenants to potential new tenants. If a competitor is advised that a location within a shopping centre is capable of generating a very high level of turnover due to information given on the operation of an existing tenant’s business, the competitor could be persuaded by the leasing agent to pay a higher level of rent than would otherwise be the case.

Sometime sales results are required to be given to a landlord as part of the leasing deal if it is a profit share deal whereby the commencing rent is low and both landlord and tenant recognise the high level of risk attached in establishing the business and agree that if it is successful then a percentage of future sales will become rent.

Fitouts

The cost of a typical fitout in a retail shop with an area of about 100 square metres falls within the range of \$200,000 to \$300,000. If the lease term is only five years that investment in fitout must be written off over the five year term. If the fitout costs \$250,000 and interest is 8% the annual expense to the retailer will be approximately \$60,000.

At the end of the lease when a lease offer is put to the tenant it will typically include "a critique report" of the fitout and often require a substantial upgrade of the fitout or sometimes a complete replacement of it. It is included in lease negotiations as a "red herring" position taken by the landlord. Unless the fitout is in poor condition, the landlord will generally accept non-replacement of the fitout or an upgrade and thereby concede a negotiation point to the tenant which will enable the tenant to pay a higher level of rent.

Conclusion

In conclusion, we will welcome the opportunity of meeting personally with members of the Committee responsible for reviewing this government initiative concerning retail leasing in Australia to answer any questions relating to our submission or on other relevant matters.

Brian C Scarborough
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Signed this 15th day of August 2014

Enclosures
Shopping Centre Performance Analysis

Need for a national approach to retail leasing arrangements
Submission 3

| Centre | Year | Specialty MAT per m ² | Year | Specialty MAT per m ² | Variation | Year | Traffic Per Year | Year | Traffic Per Year | Variation |
|---------------------------------------|-----------|----------------------------------|----------------|----------------------------------|-----------|------|------------------|------|------------------|-----------|
| Westfield Penrith | 2008 | \$9,936.00 | 2013 | \$10,452.00 | 105% | 2008 | 22,700,000 | 2013 | 16,900,000 | 74% |
| Westfield Liverpool | 2008 | \$8,107.00 | 2013 | \$8,372.00 | 103% | 2008 | 14,800,000 | 2013 | 14,600,000 | 99% |
| Westfield Eastgardens | 2008 | \$10,784.00 | 2013 | \$9,296.00 | 86% | 2008 | 10,600,000 | 2013 | 10,700,000 | 101% |
| Westfield Tuggerah | 2008 | \$6,983.00 | 2013 | \$7,962.00 | 114% | 2008 | 10,400,000 | 2013 | 9,900,000 | 95% |
| Westfield Carousel | 2008 | \$10,676.00 | 2013 | \$11,105.00 | 104% | 2008 | 9,900,000 | 2013 | 11,500,000 | 116% |
| Westfield Whitford City | 2008 | \$9,250.00 | 2013 | \$8,689.00 | 94% | 2008 | 8,100,000 | 2013 | 7,400,000 | 91% |
| Westfield Chatswood | 2008 | \$9,493.00 | 2013 | \$9,081.00 | 96% | 2008 | 15,100,000 | 2013 | 16,400,000 | 109% |
| Westfield Belconnen | 2008 | \$8,361.00 | 2013 | \$7,864.00 | 94% | 2008 | 10,200,000 | 2013 | 11,600,000 | 114% |
| Westfield Woden | 2008 | \$9,481.00 | 2013 | \$8,674.00 | 91% | 2008 | 11,700,000 | 2013 | 10,800,000 | 92% |
| Westfield Kotara | 2008 | \$9,871.00 | 2013 | \$9,264.00 | 94% | 2008 | 8,400,000 | 2013 | 7,600,000 | 90% |
| Westfield Burwood | 2008 | \$9,610.00 | 2013 | \$9,536.00 | 99% | 2008 | 21,000,000 | 2013 | 12,800,000 | 61% |
| Westfield Hurstville | 2008 | \$9,095.00 | 2013 | \$9,529.00 | 105% | 2008 | 17,100,000 | 2013 | 17,100,000 | 100% |
| Westfield West Lakes | 2008 | \$8,861.00 | 2013 | \$9,688.00 | 109% | 2008 | 7,700,000 | 2013 | 7,400,000 | 96% |
| Westfield Mt Druitt | 2008 | \$7,919.00 | 2013 | \$7,861.00 | 99% | 2008 | 12,000,000 | 2013 | 12,400,000 | 103% |
| Westfield Sydney | 2008 | \$15,337.00 | 2013 | \$16,482.00 | 107% | 2008 | 19,400,000 | 2013 | 42,900,000 | 221% |
| Westfield Parramatta | 2008 | \$9,521.00 | 2013 | \$10,155.00 | 107% | 2008 | 28,100,000 | 2013 | 28,400,000 | 101% |
| Westfield Fountain Gate | 2008 | \$9,696.00 | 2013 | \$8,816.00 | 91% | 2008 | 13,200,000 | 2013 | 15,100,000 | 114% |
| Westfield Marion | 2008 | \$10,721.00 | 2013 | \$11,030.00 | 103% | 2008 | 15,600,000 | 2013 | 14,500,000 | 93% |
| Westfield Southland | 2008 | \$8,520.00 | 2013 | \$8,516.00 | 100% | 2008 | 16,700,000 | 2013 | 15,500,000 | 93% |
| Westfield Bondi Junction | 2008 | \$11,217.00 | 2013 | \$13,406.00 | 120% | 2008 | 21,000,000 | 2013 | 21,400,000 | 102% |
| Westfield Warringah Mall | 2008 | \$10,178.00 | 2013 | \$9,651.00 | 95% | 2008 | 14,015,000 | 2013 | 12,600,000 | 90% |
| Westfield Chermide | 2008 | \$10,297.00 | 2013 | \$13,434.00 | 130% | 2008 | 15,900,000 | 2013 | 15,900,000 | 100% |
| Westfield Carindale | 2008 | \$10,779.00 | 2013 | \$10,788.00 | 100% | 2008 | 14,900,000 | 2013 | 16,200,000 | 109% |
| Westfield Miranda | 2008 | \$11,256.00 | 2013 | \$11,698.00 | 104% | 2008 | 14,100,000 | 2013 | 11,100,000 | 79% |
| Westfield Garden City | 2008 | \$9,993.00 | 2013 | \$8,915.00 | 89% | 2008 | 13,100,000 | 2013 | 12,300,000 | 94% |
| Westfield Hornsby | 2008 | \$7,569.00 | 2013 | \$7,938.00 | 105% | 2008 | 16,300,000 | 2013 | 16,600,000 | 102% |
| Average | | \$253,511.00 | | \$258,202.00 | 102% | | 382,015,000 | | 389,600,000 | 102% |
| CPI All Capitals | 2008/2009 | 92.6 | 2012/2013 | 102.3 | 110% | | | | | |
| Specialty Shop Rental Growth | | CPI | Plus 2% | | | | | | | |
| CPI All Caps plus 2% per annum | 2008/2009 | 92.6 | 2% | \$1,000 | | | | | | |
| | 2009/2010 | 94.8 | 2% | \$1,044.23 | | | | | | |
| | 2010/2011 | 97.7 | 2% | \$1,097.70 | | | | | | |
| | 2001/2012 | 100 | 2% | \$1,146.01 | | | | | | |
| | 2012/2013 | 102.3 | 2% | \$1,195.82 | 120% | | | | | |