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20 February 2015

Department of the Senate
SG 64. Parliament House
CANBERRA ACT 2600

PUBLIC HEARING, 13 FEBRUARY 2015 – ENQUIRY INTO THE NEED FOR A NATIONAL APPROACH IN RETAIL LEASING ARRANGEMENTS

We provide the following answers to the additional questions from Senator Xenaphon .

Q1 Do you consider first rights of refusal for sitting tenants a fair way for landlords to deal with tenants at the end of their lease? Are there any alternative approaches worth considering?

First rights of refusal for sitting tenants can be a fair way for landlords to deal with tenants at the end of their lease subject to several provisos.

It cannot be an opportunity to match lease terms and conditions negotiated with a replacement tenant even if that replacement tenant has the same permitted use as defined for the sitting tenant.

If the sitting tenant has built a substantial business as a result of entrepreneurial effort, the offer the sitting tenant will be required to make to match the offer from the replacement tenant will more than likely include an additional rent in recognition by the replacement tenant of the profit potential of the site.

The only fair way to set the rent is by negotiation, but if that fails, then by independent market rental determination by a valuer who is bound by the rules of market rental definition. Those rules exclude good will and fitout owned by the tenant and does take into account the permitted use and all other terms and conditions of the lease.

First rights of refusal do not work where there is no offer made by a replacement tenant for the sitting tenant to consider and match. This will be the case if the sitting tenant is paying a rental well in excess of market level as the lessor is content to receive ongoing rental payments by the sitting tenant who remains on a monthly tenancy rather than put the tenancy on the market.

Tasmania has the best commercial tenancy legislation which solves this problem. If the landlord offers the sitting tenant a renewal of lease and the sitting tenant wishes to renew the lease then, if commencing rent for the new term is not agreed it is set by an independent valuer. If the rent is set at a level which the sitting tenant believes is too high for its business to pay, the sitting tenant does not have to renew the lease which is unaffordable.

One of the reasons why tenants need to negotiate terms for a new lease at the end of the current lease is to ensure there is enough time to amortise the cost of fitout at an affordable annual rate.

At present, most commercial lease legislation provides a minimum term of five years for every lease. This is generally not enough time to amortise the cost of an expensive fitout so at the end of the lease term the tenant will of necessity pay more rent than is necessary in order to ensure they have enough time to pay off any outstanding debt they still have to a bank for their loan to cover the cost of fitout.

Rather than have first rights of refusal, an alternative is for every retailer who is required to fitout 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 fitout (other than what can be salvaged and installed elsewhere).

It eliminates the double loss which a tenant trading from a business which is losing money suffers. They are not only losing money by staying put and running a business at a loss, they are also prevented from relocating the business elsewhere shifting their plant, stock and staff to another premises which would enable them to generate a profit – hence the double loss of staying in premises where the tenant is losing money.

Of course the tenant would not terminate a lease without giving the whole matter serious consideration as the cost of termination, although not resulting in a penalty payout to the landlord would still result in a substantial penalty being paid by the tenant anyway as the debt to the bank (if the fitout is financed) would have to be paid out.

The ability for both landlord and tenant to implement market reviews of rent which covers a situation whereby the landlord may have inadvertently done something which has had a serious impact on the profitability of the tenant's business. The market review of rent may remedy that, in which case the tenant would stay and pay the reduced level of market rent or if it didn't solve the problem the tenant would terminate and vacate.

From the landlord's perspective it would ensure the landlord thought twice before doing anything which might impact on any existing tenant's business knowing that a market review of rent would address the problem from the tenant's perspective.

It would also enable the landlord to reap the benefit of a market review of rent in the event of the landlord investing in the property which has the effect of attracting more customers, generating more sales and giving the tenant the ability to pay more rent. The market review of rent should identify that and give the landlord a fair return on investment.

The main negative, of course, will come from landlords who do not like the idea of losing control of the contract with their tenant to pay rent and stay put for the entire term of the lease. It would, however, solve many of the other problems we have identified in leases particular those relating to how the renewal of lease is handled at the end of the term and getting the preferential rights/first right of refusal rules sorted out so they are fair and reasonable to both parties.

Q2 Is a national lease register worth having? If so, why?

A national lease register is worth having provided it is affordable, searchable and includes incentives, rent free period, capital contribution, landlord works, etc.

Affordable
Searching leases in state managed databases (NSW, QLD & ACT) is expensive and haphazard in terms of the relevance of the data that can be obtained.

The commercial elements of leases are not extracted to enable searches to produce just the information which is relevant for rental comparison purposes. When you search a lease you have to buy the whole lease which can be up to 100 pages. Often the relevant data is buried in the paragraphs in the lease, it is not always easily extracted by reference to schedules.

They almost never include incentives, rent free periods, capital contributions, early terminations, etc.

A national register would work if there was a standard form required to be filled out by landlords setting out all the commercial terms in a tenancy schedule format which could then be electronically registered. That would be a very useful and affordable tool. It could be cheaply managed and highly beneficial for all players in the retail/commercial leasing sector.

Q3 What is the single most important legislative issue you consider should be changed and applied to all retail and commercial leases in Australia?

All leases should exclude ratchet clauses whenever there is a market review of rent.

In South Australia the cut off amount for leases to exclude them from the Act is where rent is greater than $400,000 per annum.

We have many situations now where our clients entered into leases several years ago with rights of renewal with commencing rent under $400,000 but as result of rent reviews is now in excess of $400,000. 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.

I cannot accept there is any circumstance where if it is agreed for a market rent review to be implemented, it should result in the rent being set to market level.

Thank you for the opportunity of providing these additional answers to those questions, please let me know if I can be of further assistance in this matter.

Yours faithfully

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