
6 Security of tenure

Many of the current regulations in the retail tenancy market have been put in place with the intention of providing retail tenants with greater security of tenure. Despite this, many tenants expressed concerns to this inquiry in relation to tenancy security, with some suggesting that the current provisions ‘have not done enough’.

Section 6.1 presents participants’ views on the current arrangements. Section 6.2 provides evidence to place these views in a broader market context. Section 6.3 then assesses the various suggestions made for further regulation to influence tenancy security. Section 6.4 summarises the issues raised in the chapter.

6.1 Participants’ views

The issues raised by tenants and tenant advocacy groups relating to security of tenure during this inquiry were broadly aligned with those raised in the Reid Committee report a decade earlier. The specific tenure issues raised related to:

- minimum lease terms;
- the ‘vulnerability’ of tenants at lease renewal; and
- ‘loss’ of goodwill at the end of lease.

Of the 50 plus initial submissions received from tenants, around half addressed security of tenure issues. Tenure issues were also raised by the majority of tenant advocacy groups making submissions to the inquiry. One retail representative claimed that ‘the most common source of despair for retail tenants is how they are treated at renewal or when their lease terminates’ (confidential submission). Security of tenure also received considerable attention in the inquiry draft report hearings and submissions commenting on the Commission’s draft report.

Minimum lease terms

Many retailers said that they face difficulties in negotiating lease terms longer than five years. Some suggested that the five-year minimum lease term (a provision incorporated in most State and Territory legislation in a bid to improve security of tenure for tenants) has become a maximum lease term. For example, the Pharmacy

Guild stated:

... when enacted, the five-year minimum term was envisaged to be the *minimum* period over which a lease could be granted. In practice, it has evolved into the *standard* term granted. (submission no. 109, p. 15)

The Australian Retailers Association (ARA) also argued that lease term options in shopping centres ceased with the minimum lease term provision:

The offering of an option for a lease in regional and sub-regional shopping centres ceased in about 1994 when fixed terms of five years became the minimum term that a landlord was required to offer a tenant for a retail shop. That five-year term has become the term. (submission no. 119, p. 18)

One reason for retailers' concern is that a five-year term is considered to be an insufficient period to amortize capital costs. As Ipswich Leisure Centre put it:

A business needs tenure to set-up, build up and close-down. Within a 5 year lease term, it is impossible, the business being most vulnerable at lease renewal with fixtures and fittings not yet written off. (submission no. 30, p. 1)

Some attributed this concern to differences between the lease period and the period allowed by the Australian Taxation Office (ATO) to fully depreciate shop fit outs. For example, it was suggested to the Commission:

... shopping centre fit outs have risen dramatically and it's now impossible to write-off costs of a fit-out over five years. Costs of \$150 000 for an average suburban shop fit are not uncommon. The ATO will allow accelerated depreciation on some items, but many retailers take at least seven years to write down the value of their shop fittings. (confidential submission)

The Pharmacy Guild also argued that a five-year lease term:

... is still a very limited time for a high-cost/low-margin business, such as a pharmacy, in which to operate to recover establishment costs and then make a reasonable rate of return. ...

In the context of pharmacy, finance contracts or loans are generally for 10 to 15 years. The current financial operating structure of pharmacies is such that many cannot repay a loan in less than 10 years. (submission no. 109, pp. 15-6)

More generally, the ARA argued that:

The five years that has become the norm in shopping centres clearly needs to be extended given the investment that they are forced to undertake as a condition of complying with the fit out standards required by the landlords. If the retailer is unable to renew the lease, not only is there the economic loss associated with what is left on the balance sheet but also the cost of removing and disposing of the fit out, most of which is unsalvageable. This cost is of the order of \$20-30 000. (submission no. 119, p. 24)

At the draft report hearings, a few participants reiterated the need for longer minimum lease terms. For instance, COSBOA stated:

In its submission COSBOA asserted that a seven-year lease should be the minimum term. Landlords suggested they need full control over their shopping centres to allow them to control the tenancy mix, and this is true. A tenancy mix of a shopping centre is critical, to allow it to change with the marketplace. What has not been said is that it doesn't change and evolve that fast.

The time of a retail life cycle is shortening. However, seven years gives retailers ample time in which to set up, depreciate and close down, and enough time for landlords to plan properly. (transcript, p. 282)

Similarly, the Queensland Retail Traders and Shopkeepers Association said that five years was too short to recoup the cost of expensive fit-outs, noting:

What we try to say is eight years for taxation implications. But maybe a suggested range should be five to eight years. What that does is it forces the parties to think. It forces the parties to say, 'Okay. Mate, do you want me to spend \$3000 per square metre on a fit-out? Zero based accounting, how can I do it in five years, and you want X rent? It's impossible. The numbers are not going to work.' (transcript, p. 448)

ATO rulings suggest that the effective life of retail assets for amortisation purposes is in excess of five years for many items — five years for certain electrical items and electronic security equipment, but up to 10 years for counters, shelving and flooring and 20 years for billboards/hoardings and some specialised items such as food preparation benches and fixed chairs and tables in cafes (ATO 2007).

A different perspective on lease terms

The perspective on minimum lease terms from one landlord with a small shop, however, was quite different. The landlord claimed that it was her experience that tenants do not want to take on leases as long as five years (recognising that this is a different scenario to that in large shopping centres):

In my experience, it is the tenant who does not wish to take a 5-year lease. In fact, if I could procure a tenant who wanted to take such a lease term, I would be grabbing them with open arms. (confidential submission)

The small-business landlord also argued that it should not be necessary for a tenant to seek instruction from a solicitor in order to take a lease for a shorter term.

Some tenant organisations also noted that lease terms need to be flexible to accommodate a range of uses. For instance, the National Retail Association (NRA) said:

We don't advocate minimum lease terms, for the simple reason that a bookshop would have entirely different needs to a highly capitalised coffee shop, for instance.

(transcript, p. 411)

Similarly, the Retail Traders Association of WA noted that small retailers had stressed the importance of maintaining flexibility in lease terms to allow new tenants the ability to test the market without locking into a long-term lease (submission no. 65).

The vulnerability of tenants at lease expiry

Limited negotiating power of retail tenants in shopping centres at the time of renegotiating a lease was raised as a source of difficulty by numerous retailers and retail representative groups. Many participants suggested that landlords exploit their superior bargaining power when a lease expires by either seeking ‘excessive’ rent increases or ‘forcing’ tenants to terminate their business (or relocate within a shopping centre). With limited alternatives, particularly where one shopping centre dominates retail sales in an area, tenants consider themselves to be ‘sitting ducks’ — they take the offer or leave.

A number of retailers indicated that while they were able to drive a hard bargain when negotiating new leases in shopping centres (because shopping centre managers wanted the retailers in the centres), they found the situation quite different when negotiating a subsequent lease. The ARA, for example, described the shopping centre tenant as an ‘economic captive’ at the end of the lease:

The difficulty that arises at the end of the lease is the position of the sitting tenant in a shopping centre where he or she is an economic captive having invested heavily in a fit out, stocked the shop for the term of the lease and contributed substantially to the asset of the landlord. If the tenant is to vacate they are confronted with the loss not only of their goodwill and also the value of the business as a going concern and their livelihood for the majority of small businesses. (submission no. 119, pp. 22-3)

Similarly, the Australian Newsagents’ Federation argued that:

... landlords are well aware that it is difficult and expensive for any retailer to relocate once established. When it comes to a lease renewal, the tenant’s business is a going concern with much of the business’ goodwill tied to its retail location. Under these circumstances the tenant cannot simply walk away from negotiations without facing serious repercussions on their business investment. For landlords to argue that competitive forces remain constant once retail businesses become entrenched is difficult to accept. (submission no. 72, p. 2)

The NRA also suggested that:

End of lease and lease renewal is a very different market environment. It’s like the difference between getting married and getting divorced, as an analogy. That negotiating environment is a pretty reasonable analogy, I think. The end of lease is the

crucial issue in the whole debate. (transcript, p. 413)

Limited bargaining power at lease expiry appears to be less of an issue for larger retail tenants and those operating in retail strip locations. Herro Solicitors, for example, said:

... larger tenancies do have greater bargaining power and the writer readily sees this in day to day legal practice, where the 'mini major' tenant has considerably greater bargaining power as against the small tenant. (submission no. DR175, p. 1)

In terms of retail strip locations, property ownership is more widely dispersed and there is greater opportunity to secure alternative retail premises than is the case in large shopping centres. For example, the NRA claimed:

The great majority of retail premises in Australia are in 'main street' locations, with widely dispersed property ownerships, and generally substantially lower sales and rentals. With some exceptions, these are more benign landlord-tenant relationships, due to supply/demand factors, wider availability of alternative premises for existing tenants on lease expiry, with somewhat better negotiating positions relative to shopping centre tenants for whom there are usually no feasible alternatives in any particular case. (submission no. 47, p. 6)

A similar point was made by the Post Office Agents Association. It claimed that licensees who rent retail space in a shopping strip generally have a reasonable chance of driving a hard bargain with the landlord — 'true negotiations can take place, especially where there are vacancies in the shopping strip' (submission no. 10, p. 1). In the case of retail space in shopping centres, however, it claims that 'shopping centre management can choose to exercise a greater degree of control over tenants and hold greater bargaining power'.

'Loss' of goodwill at end of lease for retailers in shopping centres?

Some tenants considered that they had established business value, or 'goodwill', tied to their trading location in a shopping centre, which should be realizable by them at the end of a lease. It was also suggested that shopping centre landlords did not, at the end of the lease or in renegotiations, adequately recognise the contribution of tenants to the success of a shopping centre. As Herro Solicitors put it:

The tenant has expended capital and energy in building his or her business and establishing goodwill but without a lease this goodwill is almost worthless. This places the shopping centre owners in a strong bargaining position – the value (and sometimes the future existence of the business) depends on the grant of a lease. (submission no. 64, p. 1)

Some participants added that any goodwill that was established by a retailer in the

course of a tenancy accrued to landlords in the form of higher rent for a subsequent lease. As stated by the Southern Sydney Retailers Association:

Theft of a small retailer's goodwill and confidential information is one of the main factors determining rents in Australian shopping centres. The theft comes at lease end, where as a result of the dishonest misappropriation of a retailers confidential information, (his sales turnover) under the sham Percentage rent clause, a landlord confiscates any goodwill a retailer has created, and forces the retailer to 'buy it back' in the form of a rent increase, or auctions the retailers goodwill to competitors, again by the way of higher rents. (submission no. 137, p. 4)

Other participants, however, suggested that there was no goodwill at the end of a fixed-term lease for retail space. Westfield, for example, put the view that:

... much of the goodwill that is often claimed by a tenant can just as easily be said to be attributable to the drivers of customer traffic created by the location of the tenant's premises within the shopping centre and the tenancy mix and ambience of the shopping centre as a whole and not to factors attributable to the particular retailer's business. (submission no. 85, p. 21)

Westfield also noted that the nature of the lease arrangements, including the lease period, are set out and tenants should be well aware of this prior to entering a lease:

When a retail tenant enters into a lease of premises within a shopping centre the terms of the lease arrangement are clear, including the period of tenure which will meet at least the statutory five year minimum period and may be longer depending on what has been negotiated. Before entering into the lease the retail tenant will be aware of the rent that is required to be paid, the terms and conditions of the lease and the fact that at the end of the lease term, the lease may not be renewed or if renewed may be for a higher rent (subject of course to the retail tenant being willing to renew the lease on that basis). (submission no. 85, p. 21)

During the course of the public hearings a number of retailers indicated that they were aware of the nature of lease arrangements in shopping centres, including the finite nature of lease terms and conducted their business within this framework.

6.2 Evidence on lack of security

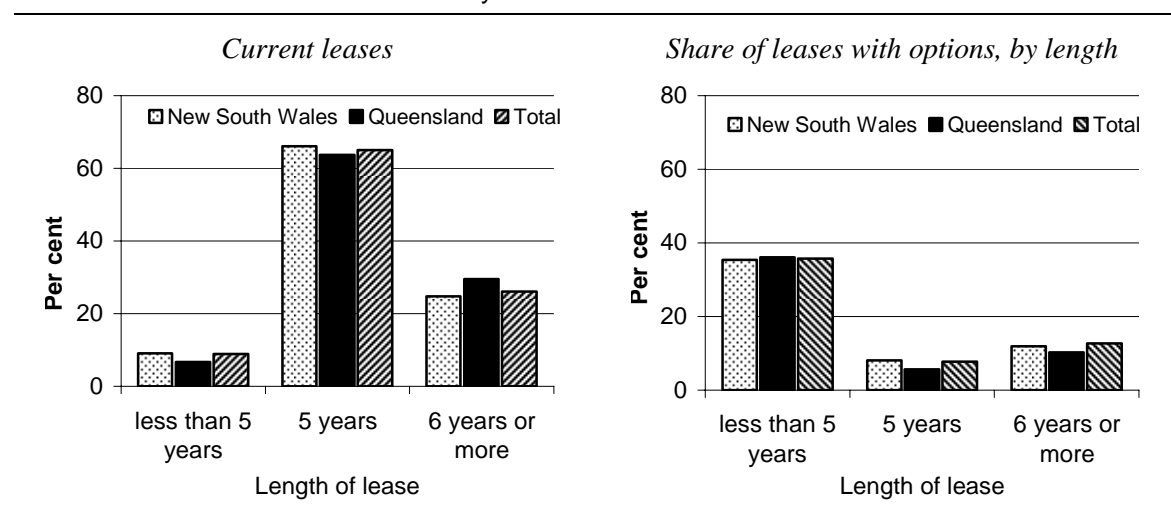
Minimum lease terms

Professor Crosby from the University of Reading submitted that an 'analysis of lease terms in Australia indicated that in shopping centres all but the anchor tenants get the minimum term with no right to renew' (submission no. 84, p. 18). An examination of lease terms in a major regional shopping centre in Victoria found that 7 out of 250 leases in the centre had terms of around 20 years (these leases were

for anchor stores), while speciality shops had leases of five, six or seven years, or leases of less than five years (submission no. 84, p. 18).

Data on lease terms for 11 970 current leases (mainly in New South Wales and Queensland) indicate that, while 65 per cent of these leases are for a five-year term — 66 per cent in New South Wales and 64 per cent in Queensland (where the five-year minimum lease term has been removed) — 35 per cent are either longer or shorter than the ‘standard’ five-year term (figure 6.1, left panel). In New South Wales, around 9 per cent of these leases were for less than five years and 25 per cent were for more than five years. In Queensland, the corresponding proportions were 7 and 30 per cent.

Figure 6.1 Lease periods similar between States and over time^a
Per cent of leases analysed



^a Based on leases in the LIS database, which is drawn mainly from registered leases. Data for current leases is based on 9062 leases in New South Wales, 2314 leases in Queensland and 11 970 leases in total across all States and Territories. Leases classed as five years include leases up to five years and eleven months.

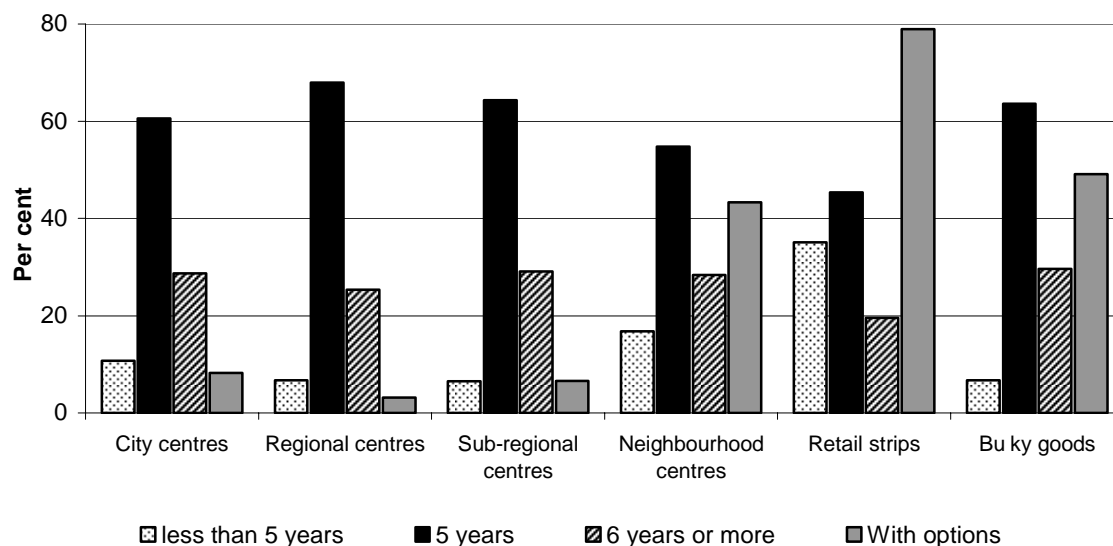
Source: Leasing Information Services (LIS) data.

The use of options also appears to be similar across jurisdictions (figure 6.1, right panel). Overall, about 12 per cent of leases analysed contained options. Options were most common amongst leases of less than five years (36 per cent), followed by longer leases (13 per cent of leases six years or longer). Eight per cent of five-year leases contained an option.

There are, however, considerable differences in lease terms between retail formats (figure 6.2). While five-year terms are the most common lease period in each of the retail formats, they are much more frequent in shopping centres, particularly the larger regional centres. Conversely, options are much more common in retail shopping strips than they are in shopping centres. For instance, 79 per cent of leases

examined in retail strips had options, compared with only 3 per cent of leases examined in regional shopping centres.

Figure 6.2 Differences in lease terms between retail formats^a
Per cent of current leases analysed



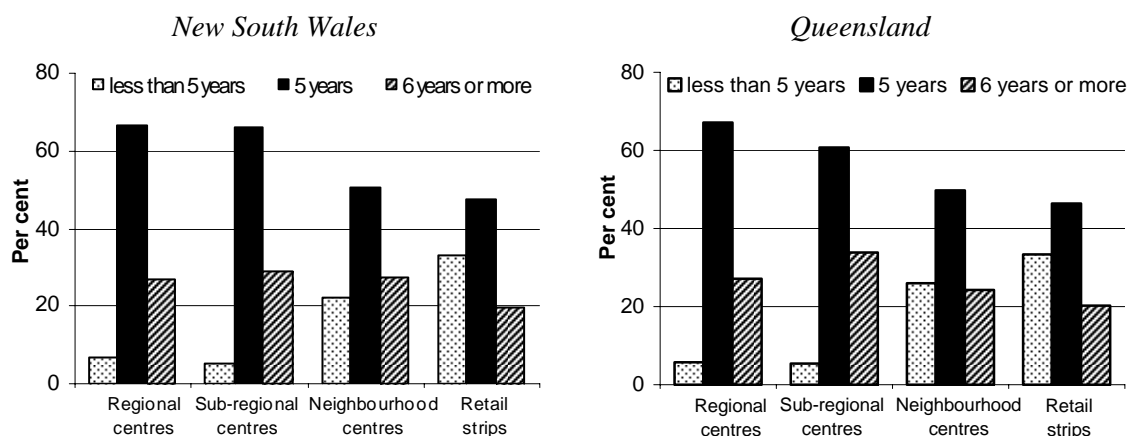
^a Based on current leases for all jurisdictions in the LIS database, which is drawn mainly from registered leases. Of 11 215 current leases analysed, 728 leases are in city centres, 7761 leases in regional shopping centres, 1817 leases in sub-regional centres, 626 leases in neighbourhood centres, 664 leases in retail shopping strips and 283 leases in bulky goods sites. Leases classed as five years include leases up to five years and eleven months.

Source: Leasing Information Services data.

The lease data analysed suggest a very similar pattern in both New South Wales and Queensland. In both jurisdictions there is substantial variation in the pattern of lease terms between retail formats, but little difference recorded for each format between the two States (figure 6.3). This suggests that the length of retail leases is less influenced by the legislative framework of the jurisdictions (whether or not there is a minimum lease term) than by the retail format.

Figure 6.3 Lease periods by retail format, New South Wales and Queensland^a

Per cent of leases analysed



^a Based on leases in the LIS database, which is drawn mainly from registered leases. Leases classed as five years include leases up to five years and eleven months.

Source: Leasing Information Services data.

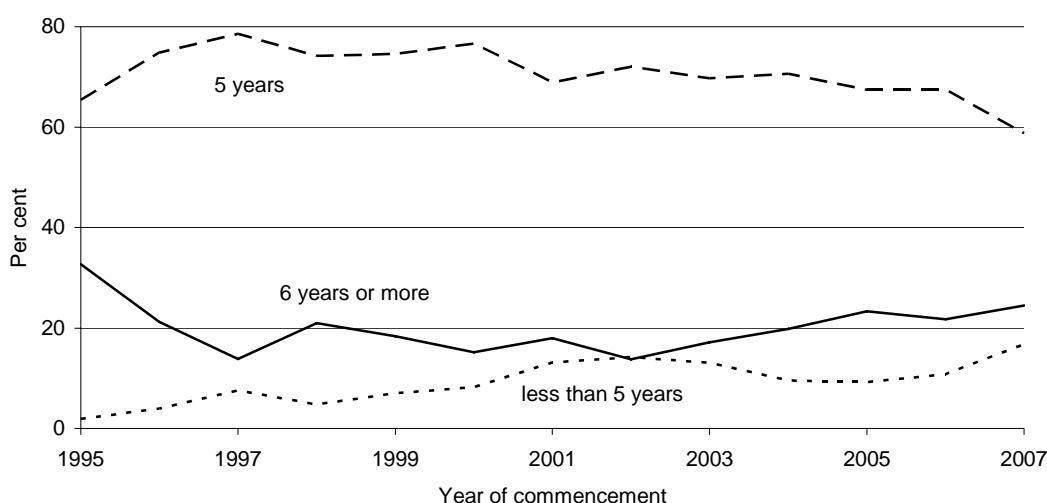
Moreover, the regulation of minimum lease terms appears to have had little long-term influence on the length of retail leases. For example, refining the analysis to leases in regional shopping centres in New South Wales indicates that while five years is the most common lease term, the incidence of five-year terms appears to have declined over the last decade. In turn, there has been an increase in the proportion of both longer and shorter leases (figure 6.4). The introduction of the five-year minimum may have initially had the effect of increasing the use of five-year terms, but over time, parties appear to have deviated from the ‘standard’ term, despite the additional cost in the case of leases shorter than five years, which must be ‘signed off’ by a solicitor.

The spread of data across formats and over time, indicates that firms successfully negotiate lease terms both longer and shorter than the legislated minimum. While interstate comparisons need to be qualified because of the small sample, there does not appear to be much difference in the range of negotiated lease periods between jurisdictions that have legislated lease minimum terms, such as New South Wales, and the jurisdiction that does not, namely, Queensland. This suggests that regulations on lease terms are having little or no sustained effects and that lease terms are primarily determined by commercial negotiation.

FINDING

A significant proportion of leases are negotiated for periods other than five years. Legislated minimum lease terms have had little impact.

Figure 6.4 Lease length by year of commencement, New South Wales regional shopping centres^a
Per cent of leases analysed



^a Based on a sample of 9613 leases in New South Wales regional shopping centres from the LIS database. The number of registered leases in the database is typically smaller in earlier time periods. For example, data are only available on 370 leases in 1995, but 928 in 2006. In 2007, data are only available for 143 leases. Leases classed as five years include leases up to five years and eleven months.

Source: Leasing Information Services data.

Incidence of lease renegotiation

Negotiations for a subsequent lease are undertaken in the context of the supply and demand for retail space. One indicator of the balance of supply and demand is vacancy rates. Information on vacancy rates presented in chapter 2 indicates that in larger regional shopping centres vacancy rates are typically less than 1 per cent. Such vacancy rates suggest strong demand for retail space in shopping centres relative to supply. In other retail formats, vacancy rates, although varying substantially according to location and format, are higher on average than rates in shopping centres (see table 2.4).

Even in this market setting where shopping centres may have a significant degree of flexibility and choice in selecting tenants, the Shopping Centre Council of Australia

(SCCA) claimed that the overwhelming majority of tenants in centres sign a subsequent lease:

... the vast majority of tenants (in excess of 80%) who have observed the terms and conditions of their lease and whose retail offer is still relevant to the customer base of that centre, do gain a new lease. (submission no. 83, p. 68)

With respect to individual market participants, Westfield reported that in 2006 roughly 75 per cent of the five-year leases for specialty shops that fell due were renegotiated and 'of the balance that were not renewed, in many instances this occurred at the retailer's instigation. In other instances, the leases were concluded amicably' (submission no. 85, p. 5). Similarly, Colonial First State Property Management indicated that, in its experience, of the leases that expired in the past year, approximately 70 per cent resulted in new leases being signed with the sitting tenant (submission no. 78, p. 4).

Three reviews commissioned or undertaken by the SCCA also found that the majority of leases in shopping centres are renewed:

- A review of lease renewal in 17 Victorian shopping centres in 2000 found that around 74 per cent of leases that expired in that year were renewed. Of the 109 leases that were not renewed, 77 were not renewed at the instigation of the tenant.
- A review undertaken in Western Australia covering 18 shopping centres and leases that had expired in 2001 and 2002, found a renewal rate of 62 per cent of leases and a 9 per cent 'holdover' rate (that is, in lease renewal negotiations). Six per cent of those leases not renewed were because the landlord did not offer a new lease to the sitting tenant.
- A similar study undertaken by the SCCA of lease renewals in the four major shopping centres in Canberra found that 89 per cent of leases that expired in 2004 were renewed. According to the survey, only 1 per cent of leases were not renewed at the instigation of the landlord (submission no. 83 pp. 68-9).

It is apparent that the majority of leases in shopping centres are renewed. However, there are instances in which sitting tenants are either not offered a new lease, or are offered leases that they consider unreasonable and do not elect to accept.

FINDING

Despite tight market conditions in shopping centres, as indicated by relatively low vacancy rates, the majority of retailers in centres are offered subsequent leases.

End of lease negotiations

Speciality retailers within shopping centres argued that they lack the ability to negotiate new lease contracts upon lease expiry — landlords are able to extract excessive rent increases and get tenants to agree to ‘unsignable’ leases.

Evidence of excessive rent increases for subsequent leases?

While the SCCA asserted that rent increases for follow-on leases are typically moderate, the Franchise Council of Australia claimed that proposed rent increases for new leases in shopping centres averaged between 30 to 50 per cent, and are sometimes over 100 per cent (submission no. 117, p. 3). The Commission was also told of cases where tenants were presented with proposed rent increases of between 30 and 115 per cent. One retailer advised the Commission:

The new lease was outrageous as it demanded approximately a seventy percent increase on the current rent which included an additional outgoings payment of \$8000. (confidential submission)

It is clear that, in renegotiating a lease for a site (or a lease for a new site for that matter), a lot of ‘hard bargaining’, goes on between parties. The Commission was told (by tenants, landlords and third parties), that initial offers by landlords were often ambit claims. In these circumstances, tenants with relatively poor negotiation skills could end up renewing leases with quite large rental increases, particularly if they were disinclined to walk away. However, evidence presented to the Commission suggests that tenants are often successful in negotiating down the asking rent for their next lease. For example, in a small sample of proposed and final rents, on average rents were negotiated down by 17 per cent on the asking rent. After negotiation, rents were recorded as rising an average of 42 per cent on the rent payable at the end of the previous lease term (table 6.1).

While rents, on average, tend to increase when leases are renewed, this is not always the case. One major landlord group submitted that, of renewals in 2005-06:

... 82% agreed to a rental increase, 15% agreed to a rental decrease and 4% were renewed on the same rental. The average increase across all deals completed in 2005/2006 was 13%. (confidential submission)

Others commented on the value of engaging independent valuers and lease negotiators to help them in lease negotiations:

Our business has also been hit hard by a recent rental hike of which we fought utilising an independent valuer. Whilst this exercise was very costly and we still incurred a substantial rent increase, we were able to peg back the initial proposed rent increase by half. (confidential submission)

Table 6.1 Examples of rent increases negotiated for a subsequent lease

<i>Annual rent paid at end of lease term</i>	<i>New lease asking rent in 1st year of term</i>	<i>Percentage increase</i>	<i>Agreed rent to be paid in 1st year of new lease term</i>	<i>Percentage increase</i>
(\$)	(\$)	(%)	(\$)	(%)
40 360	75 000	86	63 500	57
62 040	124 000	100	94 500	52
46 528	90 000	93	80 000 base	72
53 549	108 000	102	80 000 base	49
28 744	50 000	74	43 000	50
61 692	96 000	54	72 000	16
96 000	140 000	46	Unresolved	
71 196	98 000	38	85 000	19
54 000	96 000	54	74 132	37
78 000	105 000	34	99 500	28

Source: Confidential submission.

There are also situations in which substantial rent increases could be expected. Tenants may have entered leases with relatively low or concessional rents, perhaps because the premises were in an unpopular area or in a new development without an established customer base, or the tenant offered a product or service in high demand. If foot traffic (and sales) increase over the lease term, for instance due to a refurbishment or maturation of a new shopping centre, the novelty of new products or services has worn off or a better use of the space is available, it would be expected that landlords would seek to increase the rent substantially for a subsequent lease. The SCCA submitted that high rent increases for a subsequent lease:

... are unusual situations and there are generally good reasons why such rent increases have been sought. Most often it is because the tenant had previously been on a very favourable rent, well below prevailing market rents, a situation that the tenant knew was not going to continue. (submission no. 83, p. 57)

This suggests that large rent increases for subsequent leases do not automatically indicate a lack of negotiating power on the tenants' part.

Many tenants and tenant organisations also expressed the view that the requirement to provide data in shopping centres allows landlords to determine rents in new leases according to a retailers' capacity to pay rather than the 'market' rent. For example, at the public hearings on the draft report in Sydney, the ARA, said:

So they're never going to pay percentage rent, but I put to you that the figures will have — all of the actual declaration of sales figures was left in the list because clearly the landlord wanted to know how well the tenant was trading.

There is in some instances, I believe, misuse of those, and there are other times where

the perception of misuse clearly sets — especially when some of the rent increases are in the order of 20 or 30 or 40 per cent, and I'm not talking about on top of somebody who has had a very low start-up rent, and the feeling there was the guidance that the sales figures were used to basically take them to the maximum that they could take but still leave the trader in business. (transcript, p. 59)

While there is no doubt that rents charged vary considerably according to the type of retailer (see chapter 7 for a discussion on the use of turnover data to determine occupancy costs), exchanges at the hearings on the draft report failed to substantiate the claim that prohibiting the collection of turnover rent would result in landlords not being able to gauge tenants capacity to pay. The ARA, for example, also said at the Melbourne hearings:

I agree with the ability of the manager to go around and see the good, the bad and the ugly. Most people can detect whether someone has got a good operation or not, but whether any centre manager could go to one of our stores and guesstimate the sales within 20 per cent, I'd be very surprised. (transcript, p. 564)

While it may be true that without actual turnover data landlords may either over or undershoot the mark, overall the 'guesstimates' could be broadly accurate.

Large rent increases for new leases also reflects strong demand for, and a limited supply of, premium retail space (reflected in low vacancy rates in regional shopping centres). Given the low vacancy rates for retail premises in shopping centres, centre landlords may be able to drive a hard bargain, particularly if the tenant is offering a service heavily reliant on centre foot traffic for viability.

While a 'going rate' or 'market rent' typically applies in retail strips, the business model of large shopping centres is to ask retailers for rent that equates to the maximum they can afford to pay. Many small retailers appear to not understand or accept this basic reality of the rent discovery process. Having each retailer's turnover data makes it easier for centre landlords to do this more consistently and precisely.

Imbalances in negotiating power?

There is no doubt that the major shopping centre landlords have an advantage over the small independent retailer in terms of negotiating skills and bargaining power. As the LeaseWise Group indicated, they tell tenants:

... you will negotiate a lease once every five years; the landlord will do it daily, so you have to assume that they have an advantage. (transcript, p. 483)

Barry Nilsson Lawyers advised that from their experience:

... most of the tenants who have failed have been mum and dad tenants who don't have

the financial resources to know what a fair deal is and possibly don't have the resources to research the market as effectively. (transcript, p. 406)

However, there are things that tenants can do to counter the imbalances in negotiating power. As the Real Estate Institute of Australia (REIA) stated:

There is however much tenants can do to maximise their own bargaining position including; taking a rational and balanced perspective, accessing up-to-date market information, engaging the services of property professionals (real estate agents and valuers), obtaining legal advice, and obtaining financial advice. (submission no. DR154, p. 2)

Tenants can better equip themselves by employing lease negotiators to negotiate leases for them. The well informed tenant (who has sought both financial and legal advice) will also know at what point a lease becomes 'unsustainable' for their business model and will walk away from the lease negotiations.

The Commission was advised of a variety of negotiating tactics adopted by the major shopping centre landlords at lease renegotiation that could be off-putting for tenants. For example, one negotiating tactic employed by the major shopping centres is to write to tenants six months prior to the end of the lease term indicating that there will not be a new lease. As stated by the LeaseWise group:

That is something that is trained by leasing executives... they rely on a certain percentage of people to sort of panic, particularly the less highly evolved retailers, and to think that they have so much business and emotional energy invested in this particular enterprise that the sun won't come up unless they renew their lease (transcript, p. 483)

Simply being aware of such tactics can improve a tenant's negotiating position.

It was also clear that retailers adopted their own tactics to achieve more favourable outcomes. The LeaseWise group indicated that they now played the same game back to shopping centre landlords — they write a letter to the landlord indicating that the tenant wants an early exit from the centre. They claimed that:

... you'd be amazed at the reaction that you get ... the leasing executives from the majors say 'No, you can't go, we need you'. It's all about the knowledge and knowing how to negotiate. (transcript, p. 481)

In another case, after 12 months of failing to reach agreement on rent for another lease, a tenant placed advertisements in the major papers indicating that their store would be closing down. The outcome — within 24 hours the tenant and landlord had reached agreement on a lease.

Tenants economic captives at lease renewal?

The Commission was told repeatedly that small specialty retailers are vulnerable when negotiating another lease. For example, the NRA said:

In lease renewals there is a high degree of anxiety by the sitting tenant, and they may be more concerned to renew the lease even at subeconomic levels rather than face the consequences of loss. (transcript, p. 411)

Another tenant, Manna Confectionary, painted the following picture of the situation at lease renegotiation:

Let's forget the point that I've just bought a business in a shopping centre. Let's say I'm in there and I'm coming up for my five-year renewal. Let's use your boxing ring analogy. What if I have to get in that boxing ring, because if I don't, my wife and my children don't eat, my house repayments don't get made, everything collapses and I go bankrupt. I have to get in that ring and take on the heavyweight and take my chances with him, and that's where you're at. You've got so much invested in it that if you don't get in there and fight like a dog, you don't meet your commitments. (transcript, p. 790)

In many cases, however, tenants' vulnerability can at least partially be explained by the actions of the tenants. For example, the Commission heard of cases where:

- retailers had taken out business loans exceeding the term of the lease (for example, a 10-year loan and a five-year lease);
- tenants had franchise agreements beyond the length of their lease (and in some cases the terms of the franchise agreement were tied to the leased location);
- tenants were working on the assumption that a new lease would be offered upon lease expiry (having agreed to a lease term knowing that it was not possible to write-off capital costs over the lease term — the 'unsignable' lease).

The ARA, on being questioned at the public hearings in Sydney on whether the word 'renewal' led to a misperception among tenants that if they paid the rent and were good tenants that they would be offered a new lease, said:

... anyone that I advise, the first point that I make in that advice is, 'Do you realise that this term is for five, six, seven years, and at the end of that period there is no guarantee that you will get it renewed?' That virtually is my opening comment. Now, how many of them have sought advice and how many of them weren't educated to that, I'm not sure, but, you know, as a person involved in the industry it would be remiss of me if I did not highlight that very much when I've been asked for advice on it. (transcript, p. 64)

While it is true that in some cases a sitting tenant may be better off gaining a new lease for the existing premises (compared with relocating to another location), this will not always be the case (box 6.1).

Box 6.1 Tenants should not bank on a new lease being offered on 'acceptable' terms

At the end of a lease, a retailer wishing to continue trading will be faced with a choice between seeking a new lease at the same location, or seeking to relocate. In making this decision, a retailer will consider the cost of relocating (assuming an alternate site of equal quality in terms of size and location), the difference between the costs of removing the fit-out from the previous premises and fitting out a new shop compared with the cost of refitting the existing premises.

If a landlord does not require a new fit-out (as a condition of a new lease), or only a partial refit, then the cost of relocating is likely to be significant. Alternatively, if a complete refit of the premises is required then the costs of relocating will be considerably lower (the cost to make-good). The potential to use the fit-out, or part thereof, if a new lease is agreed for the existing premises means that it could be advantageous for a tenant to remain at a location.

A sitting tenant would therefore be willing to pay an additional amount in rent for a new lease for the existing shop, relative to an otherwise identical vacant new premise, up to an amount equivalent to the cost of relocation. Because landlords are aware of the cost to the tenant of moving, it is likely that landlords may be able to negotiate a higher rent for a sitting tenant, capturing some, or all, of the benefit available to a tenant from reusing any part of the existing fit-out. A Landlord's actions that increase a tenant's net cost of relocating would raise the rent that can be achieved in the next lease.

Retailers should not, however, rely on being offered an 'acceptable' new lease for their currently occupied site. Retailers can run their business in such a way that at the end of their lease term they are in a position to walk away (fit-out and set-up costs all written off or covered by reserves accumulated during the period of the lease). A number of successful retailers told the public hearings that this is how they run their businesses.

The ultimate bargaining chip available to tenants is the ability to 'vote with their feet'. But, in order to have this bargaining chip, tenants need to be able to evaluate viable rent levels for their business model and ensure that at lease end there are not outstanding claims on the business that were not funded by returns over the period of the lease (for example, furniture and fitting not fully depreciated, make good provisions). That is, tenants need to be in a position to walk away if they can not negotiate acceptable conditions under a new lease.

The potential effect of rights of renewal

One approach to addressing the security of tenure issue is legislating rights to tenants to renew their leases. This type of approach has been adopted in both South

Australia and the Australian Capital Territory. In these jurisdictions, tenants are granted the first right of refusal. However, there are a number of situations in which the landlord is not required to offer a renewal to the sitting tenant, namely:

- the landlord wishes to change the tenancy mix;
- the tenant has substantially, or persistently, breached the lease;
- the landlord requires vacant possession of the premises and does not propose to relet them within 6 months; or
- it would be substantially more advantageous to lease the premises to another tenant.

The effect of these provisions is difficult to assess. While discretion appears to rest with the property owner, empirical evidence is not available to indicate the effects of the provisions, either on rates of lease renewal or rent adjustments on renewal in these jurisdictions, relative to those where these provisions do not exist.

While some participants (tenants and tenancy advisors) were supportive of the provisions, there were also numerous participants who thought the provisions were ineffective and potentially anticompetitive. For instance, Professors Duncan and Christensen questioned the utility of the provisions:

We would strongly oppose any automatic right or preferential right to renewal of a retail lease and wonder about the utility of any of these provisions. Ultimately, even with the most complex preferred tenant provisions in South Australia, at the end of the day, a landlord can still object to the renewal of a lease on any grounds. (submission no. DR153, pp. 3-4)

Another participant argued that these provisions have ‘serious implications for investment in shopping centres in South Australia and the Australian Capital Territory, with the increase in regulatory risk acting as a significant disincentive to invest in shopping centres in those two States’. (confidential submission)

The NRA also commented on right of renewal provisions:

I think it may be going a step too far. I think the automatic right of lease — no, I don’t support that at all. That perpetuates privilege and perhaps reduces capacity to change. (transcript, p. 417)

It was also suggested that the provisions are likely to mean that landlords will be less prepared to take on riskier tenants:

The increased risk to shopping centre landlords of a tenant not performing satisfactorily (but being entitled to an automatic renewal of lease) will lead to landlords ‘playing it safe’ and giving preference to more established state or national retail chains. Faced with a choice in a new leasing situation, between an established retailer and someone seeking to set up in business for the first time, the landlord will be less inclined to take

a risk on a small retailer or would be retailers. (confidential submission)

The Commission was also told that (in the Australian Capital Territory at least) the major landlords will not execute a lease unless the party agrees to contract out of the first right of refusal provisions. As put by the LeaseWise group:

What's required by the major landlords in Canberra is a letter from the lessee's solicitor or someone acting on their behalf that by consent between the parties they remove that security of tenure clause. (transcript, p. 482)

It is questionable whether first right of refusal provisions are effective in improving security of tenure for sitting tenants. Further, to the extent that these provisions cause discrimination against new or more risky retail businesses, competition in the retail tenancy market is reduced, the efficiency of the market impeded and productivity lowered.

Loss of goodwill?

Participants submitted that different interpretations of goodwill exist. As described by Competitive Foods Australia, there are separate legal, accounting and commercial understandings of what constitutes goodwill:

Goodwill is, of course, an intangible asset of a business, and business owners count on their goodwill to attract and retain customers on a daily basis. ...

The law recognises goodwill as a form of property, although the Courts have found goodwill 'notoriously difficult to define' ... A commonly cited legal definition of goodwill is that it includes 'whatever adds value to a business by reason of situation, name and reputation, connection, introduction to old customers, and agreed absence from competition, or any of these things'. However, from a legal point of view, goodwill is treated as being inseparable from the asset or assets to which it is attached.

... the International Accounting Board has defined 'goodwill' to be 'Future economic benefits arising from assets that are not capable of being individually identified and separately recognised'. However, the only recognition given by the accounting standards to goodwill occurs at the time of sale of a business, where goodwill is recognised as the difference between the value of the business as a whole and the value of its assets. ...

From a commercial perspective, goodwill arises from a combination of the elements of location, product, people and management. A good product in a poor location, a poor product in a good location, a good product in a good location with poor staffing and so on will all produce sub-optimal outcomes. It may be possible in some cases to separate out different types of goodwill – goodwill in the business, the location or the product. However, from the point of view of the tenant or franchisee, the goodwill with which it is concerned is the value of the business which it has established at a particular location or locations. (submission no. 122, pp. 9-10)

These definitions demonstrate that goodwill has several components — location, managerial skill/capacity and product/brand (box 6.2). In all three definitions of goodwill given, as retail tenants do not own the location in which they operate, any location-based goodwill associated with a retail space would be the property of the landlord. Further, if the total goodwill of a retail business is conditional on location, its value would only exist while the tenant has the right to operate in that retail location — that is, the life of the lease as negotiated between the parties. Any goodwill would also exist only after all other expenses and lease obligations have been fully accounted for, including the full cost of fittings and make-good provisions under the lease.

Box 6.2 Components of goodwill

Goodwill can be viewed as consisting of three components:

- location;
- the human capital of the business' management; and
- its product/brand.

From an economic perspective, goodwill is representative of the future value of returns generated by a business through product differentiation on these attributes. Despite this, only one of these components is fully transferrable on the sale of a business if the location is not owned — the product/brand reputation. If goodwill is dependent on the managerial ability of the owner, it cannot (usually) be bought or sold — it lies with the individual.

Similarly, if the goodwill depends on the business location, it will accrue to the location owner. The value of this location-based goodwill would be expected to become capitalised into asset value, leading to higher rent for the retail space. This occurs through a greater willingness to pay for a particular location by a prospective tenant (the extent would depend on supply and demand for similar retail space). A higher willingness to pay would also increase the value of similarly located retail spaces, increasing rents as landlords seek to maximise the return on their investment (again, the extent would depend on supply and demand for retail space).

There was no evidence received from tenants or landlords during this inquiry to suggest that fixed-term leases for retail space (for example, a five-year lease) should be assumed in advance to be for a longer (or indefinite) period in assessing the value of a business. The commercial reality is that to be viable the retail enterprise must be able to pay for itself, including a satisfactory return on owners' capital and labour, within the term of the lease (including any options) and business plans should be prepared accordingly (see box 6.3). If this is unlikely to be achieved, the tenant should seriously question whether to sign the lease. As Murdoch, Rowland and Crosby said:

There remains an immediate need to better educate those setting up or buying existing retail businesses to the danger of capitalising locational goodwill beyond the expiry of the lease. (Murdoch, Rowland and Crosby 2001, p. 34)

Box 6.3 Goodwill and discounted cash flow

A business is only worth the value, in today's terms, of the expected future returns net of expected future costs.

Suppose a business earns a net profit, after rent, wages and other costs, of say, \$100 000 a year. As a going concern with an indefinite life, the value of a business to someone will depend on what rate of return they require to invest in the business rather than some other asset. If they expect a 10 per cent rate of return then they may value the business at \$1 million. If they are prepared to accept a lower return then they will value the business more highly. For instance if they are happy with a 5 per cent return then they might value the business at \$2 million.

However, if the business only has a fixed-term lease and no transferable assets, then the value of the business is dependant on the remaining length of the lease.

For example, for the business with a net return of \$100 000 a year, if a full term of say five years is remaining, then the business may be valued at around \$380 000, assuming a 10 per cent rate of return. However, if there is only two years remaining, then a purchaser expecting a 10 per cent return (and with identical trading capabilities) may only be willing to purchase the business for around \$170 000. That is, the value of the business with a fixed-term lease does not appreciate over time, rather it decreases as the remaining lease term diminishes.

It might be argued that this undervalues the business as it does not consider the value of the business if the lease is renewed or if the business has trading prospects in other locations (such as in a shopping strip). A potential purchaser would need to consider the probability of being offered a new lease, any change to net returns as a result of new conditions, and any additional capital outlays required for refitting the premises. If considerable refitting costs, less favourable terms and conditions and/or higher rent is expected then the net present value of a new lease may be zero. This will depend on the demand for retail space and the negotiating skills of the prospective tenant.

It became apparent to the Commission over the course of the Inquiry that many retailers — and prospective purchasers of retail businesses — apply the valuation method for an ongoing business to businesses operating on a fixed-term lease. This can lead to substantial overvaluation of a business, as demonstrated by the above examples. As a result, some purchasers of retail businesses pay too much and are then unable to fully recoup the purchase price over the remaining life of the lease.

Similarly, one market commentator suggested tenants may need to consider a retail lease as a job, rather than an asset:

Taking out a lease often means you are buying a job, not an asset. When renewal time comes, expect much of the profitability you have built over the initial term of your

lease to be eaten up in rent. A landlord may leave you with enough to pay yourself a decent wage — if you're lucky — but usually not much more than that. (Preston 2007, p. 1)

The value of the goodwill in a retail business is often difficult to assess. If the business has trading prospects in another location, its value would be determined commercially on the basis of its expected income stream and the occupancy costs of that location. The absence of any location-based goodwill under tenancy leases is part and parcel of the shopping centre model and is a result of the underlying property rights. It does not indicate an imbalance of negotiating power.

FINDING

The holding of a fixed-term lease in a shopping centre does not confer goodwill to the lessee beyond the period of the lease.

6.3 Assessing the case for change

The variation in lease terms and information received by the Commission suggests that there is no 'single' appropriate lease term. To assess whether government intervention is warranted to ensure lease tenure is secure, evidence on obstacles to firms negotiating lease terms that most suit their business would need to be demonstrated. It would also need to be established that regulatory interventions could cost-effectively remove these obstacles and reduce constraints on the efficient operation of the market. The Commission received a number of submissions from tenants and tenant groups suggesting possible changes to enhance the security of tenure of tenants. The suggestions were focused on lease terms in shopping centres and included:

- extending the legal minimum lease term; and
- placing limits on the actions that a landlord can take at the end of a lease.

Extending minimum lease terms

While a number of participants advocated that minimum lease terms be extended, there were varying views about what would be the most appropriate length of time to extend the minimum term. Suggestions included:

- a five-year term with compulsory five-year option (confidential submission);
- a minimum seven year term (submission nos. 94 and 119); and
- an eight year term with compulsory eight year option (submission no. 30).

The most common argument advanced in support of increasing minimum lease terms is that it would allow retailers more time to adequately write off their fit-out costs across the length of the lease under current taxation laws. This argument was reiterated to the Commission during draft report hearings and in submissions on the draft report. However, tax provisions are known to both tenants and landlords prior to lease negotiation, and as such, to avoid large unanticipated write-offs in the final year of a lease, lease length could be appropriately negotiated or financial models adjusted to reflect commercial realities.

A number of participants also suggested that extending minimum lease terms would reduce the number of lease renegotiations and, therefore, the potential for large rental increases. With the current five-year minimum term, some participants argued that landlords have the potential to enforce ‘unsustainable’ increases in rent. For example, the Franchise Council of Australia stated:

The relatively short lease terms are of concern to the franchises due to the significant level of rental increases proposed by the landlord upon lease renewal. (submission no. 117, p. 19)

However, if rent increases are in response to market changes, limiting rent increases on a subsequent lease would reduce the efficient operation of the market by maintaining under-performing tenants longer than would otherwise be the case. Changing legislated minimum lease terms would not be effective in improving efficiency.

Extending legislated or regulated minimum lease terms, to the extent that they bite, could also further reduce flexibility for those tenants who would prefer a shorter term arrangement due to commercial risks or the nature of their business. Indeed, this was recognised by the Queensland Government when it removed minimum lease terms from its legislation (see chapter 3).

In all jurisdictions where legislated minimum lease terms apply, shorter lease terms can be negotiated. However, for the lease term to be legally binding under relevant retail tenancy legislation, the shorter term must be endorsed by the lessee’s solicitor. While this requirement does not necessarily add to disclosure or analysis of information pertinent to lease obligations, it can:

- unnecessarily add to complexity and compliance costs of lease negotiation, for example, for a short-term lease in a shopping strip; and
- lead, by example, to a lease term that does not align with the preferences of the lessor and lessee.

One small landlord submitted that their costs for preparing a very simple lease went from \$200 (as prepared by a local real estate agent) up to \$900 (now prepared by a

solicitor), following legislation changes in New South Wales in 2006.

Because the legislated minimum lease term becomes the default period if the endorsement requirement is not met, the potential exists for the minimum term provision to be exploited by the tenant/landlord to achieve a longer lease term for retail space than initially negotiated.

In addition, for some landlords, extension of minimum lease terms could hamper their ability to find tenants in circumstances where they were only able to offer short-term leases, for instance, in times before renovations or low demand. More importantly, it could substantially reduce the landlord's ability to alter the tenancy mix in response to new products or changes in consumer demand. This could constrain efficient investment in retail space, and disadvantage consumers.

Moreover, data suggest legislated minimum lease terms are ineffective in increasing lease terms for retail tenants. However, they do increase transactions costs in negotiating shorter lease terms, and in such cases impede the efficient operation of the market for retail tenancies. It is the Commission's assessment that lease terms should be a matter for commercial negotiation between landlords and tenants. The Commission notes that legislated minimum lease terms can disadvantage some businesses and raise compliance and administrative costs.

Prescribing greater security of tenure at lease expiry

Suggestions for improving the security of tenure for *incumbent* tenants when their leases expire included:

- legislating for 'fair' treatment during lease renewal or end of lease negotiations (submission no. 65);
- offers for renewal, lease negotiations and dispute processes be mandated to be completed at least six months prior to lease expiry (submission no. 65);
- tenants to be provided with at least eight weeks to decide whether to remain on the lease after dispute settlement during lease renegotiation, in which time the landlord cannot find an alternative tenant (submission no. 9);
- the onus of non-renewal be placed on the landlord — landlords have to demonstrate why a lease is not renewed, and if they cannot, the lease must remain with the current tenant (submission no. 63);
- mandatory first right of refusal for all existing tenants (as in South Australia and the Australian Capital Territory) who have adhered to their lease conditions (submission no. 118);
- mandating that when a landlord offers renewal of a lease and if negotiations fail,

-
- there is a rent determination that is binding (submission no. 47); and
 - when a lease is not renewed, the landlord be liable for lost ‘goodwill’ and the going concern of the business including fit-out costs not written off over the term of the expired lease (submission nos. 47, 109 and 122).

It was argued by some that renewal of a retail lease should be a ‘right’ of tenants and there should be greater certainty in their continuing to conduct their business operations in a pre-existing location. This certainty is believed to lead to a number of advantages for retailers. As stated by the Pharmacy Guild of Australia:

Having a degree of security of tenure is important so that reasonable employment security for employees can be provided. (submission no. 109, p. 15)

For retail tenants, mandated renewal clauses are also perceived to have the potential to place downward pressure on rents. International evidence suggests that such clauses are correlated with lower rental increases. As put by Professor Crosby:

... research in both the UK and US strongly suggests that renewal rents in shopping centres are higher than new letting rents when no rights to renew exist but are generally lower across all commercial markets when they do. (submission no. 84, p. 5)

However, if lower rents are indicative of landlords having less ability to replace poorly performing tenants, then such an outcome would mean retail space was not being put to its best use.

The main disadvantage of mandating lease renewal is that on average it potentially benefits lower productivity tenants at the expense of more productive potential tenants, that is, tenants willing and able to pay higher rents. As such, mandating lease renewal would discriminate against higher performing businesses or innovative new businesses seeking scarce retail space, particularly in shopping centres. As the REIA put it:

... it is important to remember that the landlord is also operating a business and, like their tenants, seeks to maximise the return on their investment. For this reason, some landlords may argue that they should have the right to lease their premises to the highest bidder at any given time.

If retail tenants were allowed to remain in a premises indefinitely, more successful retailers would be prevented from entering the shopping complex, to the detriment of consumers, the landlord and the overall tenancy mix (and therefore the other retailers located in the complex). (submission no. 112, p. 5)

While many submissions commenting on lease renewal referred to tenancies in shopping centres, retail tenancy legislation and its provisions extend to a much wider set of commercial transactions between tenants and landlords such as those between small landlords and retailers in shopping strips. Given this, it is likely that lease renewal clauses, as suggested in some submissions, would increase the

complexity and cost (both compliance and unintended) for those tenants and landlords that operate outside shopping centres — some 80 per cent of tenancies (chapter 2).

It is the Commission's assessment that prescribing additional provisions in an attempt to enhance security of tenure provisions for retail tenants creates additional complexity, and if anything, frustrates lease negotiations. Further, during the inquiry the Commission did not receive evidence to support the claim that these would be effective in substantially enhancing security of tenure. Instead, they would introduce inefficiencies to the market that would raise costs for landlords and tenants and lower benefits to consumers.

Would these possibilities constrain efficient market operation?

Legislating for an extension of lease terms or for the provision of greater security of tenure for incumbent tenants, represent calls for government to intervene to determine commercial terms and conditions of retail leases. In most business contracts, such matters are left to commercial negotiations between the parties to a lease. Government intervention would reduce the ability of both parties to negotiate a mutually beneficial outcome. This is no different in the market for retail tenancies. Further, where prescriptions bite, the legislative interventions would constrain the efficient operation of the market through reduced flexibility in allocating retail space to its best possible use.

FINDING

Regulation to improve security of tenure is likely to be largely ineffective. To the extent any effect is felt, it would reduce flexibility, constrain efficiency and raise compliance costs.

6.4 Summing up

Available information is not supportive of the view that measures to improve security of tenure for shopping centre tenants have been effective. Furthermore, successful retailers are well aware of the shopping centre model (including fixed term leases). They structure their business in such a way that they only sign leases if they can expect to cover all establishment costs and earn an appropriate return on capital within the agreed lease period.

Retailers in shopping centres can get into trouble when they do not recognise this model and mistakenly assume that leases will be renewed on favourable terms, and

the value of their business will appreciate — allowing them to sell the business for a substantial capital gain.

To the extent that provisions to improve security of tenure provide any benefits to sitting tenants, they create barriers to entry within the market. This disadvantages some tenants (including potential new tenants), as well as landlords, hampering the efficient operation of the market and lowering productivity.

