

# **THE AUSTRALIAN RETAILERS ASSOCIATION**



## **Economic Structure and Performance of the Australian Retail Industry**

**SUBMISSION TO**

**Productivity Commission**

**May 2011**

## **Submission by:**

### **Australian Retailers Association**

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## **Australian Retailers Association**

### **- Promoting and protecting retailers for over 100 years**

For over 105 years, the Australian Retailers Association (ARA) has been the peak industry body in Australia's \$292 billion retail sector which employs over 1.5 million people. We provide leadership and solutions to improve the long-term viability, productivity and visibility of the retail industry by proactively dealing with government, media and other regulatory bodies on behalf of our members. ARA members comprise a diversity of sizes and types of retailers reflecting the profile of the retail industry, ranging from large national chain retailers to one-person operators throughout the nation.

The ARA provides a range of comprehensive services, advice and representation suited to both small and large retailers in the areas of employment relations, occupational health and safety, tenancy, consumer law and retail business solutions. This includes a range of retail specific training that supports best practice in retail. As an incorporated employer body under the Fair Work (Registered Organisations) Act 2009, the ARA promotes and protects over 5000 independent and national retailers.

## Introduction

Retailers in Australia are facing an increasingly difficult operating environment. In the last ten years, the structure of the retail sector has shifted and evolved as a result of globalisation, advances in the digital economy, and changes to business practice policies (such as employment and tenancy frameworks). In addition, the retail sector has experienced various economic environments with the Global Financial Crisis and fluctuating Australian dollar having a significant effect on the performance of the industry.

At a business level, there are several challenges facing retailers. These include: the long-term ramifications of award harmonisation; retail tenancy agreements which mostly bias landlords; the oligopolistic nature of major shopping centre ownership; and the proliferation of offshore online channels which present an inherent disadvantage to Australian retailers in terms of equitable competition. Indeed, these matters are placing strain on domestic retailers with many finding it increasingly difficult to successfully run a business in Australia.

Given these challenges, the Australian Retailers Association (ARA) welcomes the opportunity to participate in the Productivity Commission's inquiry into the *Economic Structure and Performance of the Australian Retail Industry*. The ARA seeks to explore the context of the Australian retail industry currently, and in particular, will clarify the key challenges facing the retail industry as outlined above.

## Retail tenancy agreements and shopping centre ownership

At the outset, there are certain facts which need to be made clear in order to demonstrate the overwhelming market dominance of shopping centres in Australia. Within the Australian retail market, shopping centres provide an eco-system for \$84 billion in retail sales each year. These sales take place across 1,338 individual centres, encompassing sites in excess of 100,000m<sup>2</sup> and generating sales of more than half a billion per year and including smaller centres of ~5000m<sup>2</sup> which sustain a market of \$30 million. Most significantly, shopping centres are very productive, accounting for nearly 41% of all retail sales, although taking up less than a third of available retail space. The large centres attract in excess of 15 million shopper-visits per year and thus are such a dominant market player, even large retailers must engage with them or lose a valuable commerce channel<sup>1</sup>.

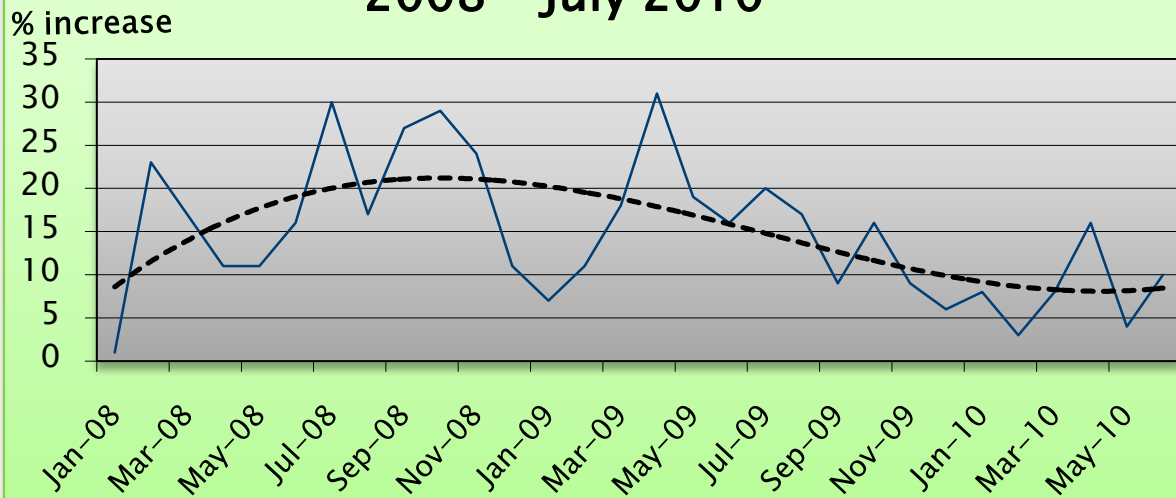
Moreover, regional shopping centres and sub-regional centres remove any capacity for genuine competition in the marketplace from strip shopping centres, such that there are only a handful of strips shopping centres that remain really commercially viable, usually in the form of destination shopping precincts. Examples of this include Chapel St in Melbourne, Bridge Rd in Richmond, Mailing Rd in Camberwell, or Oxford Street and Double Bay in Sydney. These strips are mainly located in the inner suburbs though exceptions do exist in regions such as boutiques “piggy-backing” off other central attractions for instance Leura in the Blue Mountains, Mittagong and Bowral in NSW or Daylesford in Victoria.

It is also apparent that as rents continue to increase across the economy, but particularly in retail tenancy, and with business margins not growing substantially or indeed showing signs of sustained recovery, there is a sustained exodus from the market. Indeed, analysis of data sourced from the parliamentary library suggests that prior to the 2010 election, small businesses employing up to four staff fell to approximately 497,000 down from nearly 529,000 in 2007.

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<sup>1</sup> Shopping Centre Council of Australia, <<http://www.scca.org.au/HTML%20Pages/Research.htm>> accessed 5 May 2011

## Sitting Tenant Renewal Patterns Jan 2008 – July 2010



Source: *Leasing Information Services – NSW Sitting Tenant Renewal Patterns, 2010*

The dependency retailers face upon securing tenancies within shopping centres poses a significant structural challenge to the ongoing viability of the sector. The oligopolistic nature of shopping centre ownership and a retail tenancy regime which is skewed in favour of these large-scale landlords presents an inherent disadvantage to Australian domestic bricks and mortar retailers in terms of equitable competition.

Obviously within these centres, the smaller an individual business is, the greater the disparity in the power dynamic between the retailer and the landlord. This factor is further compounded by the very real notion that large-scale shopping centres are oligopolistic in nature. The fact that companies such as Stockland, Centro, Westfield and AMP are really the only providers in the market, retailers (even one with branches across different jurisdictions) are reliant upon securing sites within these premises. In addition, smaller retailers are further exposed to the inherent imbalance in the rental arrangements particularly when negotiating and continuing retail leases.

Indeed, the oligopolistic nature of the market is further compounded due to the prevalence of cross-ownership in the centres. In practice, whilst there may appear to be a market of competing shopping centre owners, these are in fact shared ventures where centres may be 25% or 50% joint-owned by consortia. This increases the capacity, or indeed prevalence, of the sharing of turnover figures relevant to individual retailers, leading to greater inequity in the marketplace for retailers attempting to negotiate with these consortia landlords.

There are four distinct issues that retailers within shopping centres are currently facing in relation to retail tenancies:

1. In addition to the base rental cost, significant additional rental expenditure is imposed through 'Turnover Rent' whereby, built into the rental agreement, the landlord is entitled to a percentage of takings in addition to the minimum rent.
2. A retailer conducting their business in a rental premise has little long-term certainty and thus the significant costs associated with set-up and/or relocation are heavily leveraged at the point of re-negotiation. Due to the standard terms of a lease, which is usually five or seven years, a retailer has no security and can be told to leave the premises for the simple reason of 'not fitting' with the centre's image, notwithstanding their investment into the retail space. Additionally, the retailer is subjected to the perceived threat that an alternative tenant is prepared to pay more for the same tenancy.
3. Based on the abuse of the 'Turnover Rent' provision, landlords are able to determine a rent increase which is geared within what a retailer 'can afford to pay' rather than a common and transparent market rate mechanism thanks to accrued data provided under the 'Turnover Rent' clauses.
4. In the period after the current lease term is expired, but prior to a new lease being agreed to, the tenant is regarded as being the occupant month-to-month under a 'lease holding over' period. If, and when, a new lease is signed at a different rate, the retailer is obliged to back-pay the difference and this is obviously an un-budgeted and un-expected financial burden to the individual retailers.

Evidently, these issues are of concern to retailers, particularly SMEs whose negotiations with their landlords, which may simply be based on motives driven by profits and judgements made purely based on a retailer's financial position. In this case, for the SME, retail tenancy re-negotiations can actually be very personal and can be subtly or overtly manipulated.

The ARA's grave concern is that there is presently no effective mechanism to accurately determine the market rate of commercial tenancies. The tenancy is initially calculated incorporating a theorised retail turnover figure and at the point of re-negotiation specific data has thus been collated by the landlord and then aggressively leveraged. This exacerbates the power imbalance between the parties. Moreover, the ARA objects to this practice as there is no comparable data provided to the tenant of the works or strategies undertaken by the landlord which would indicate their contribution to profitability other than providing a premises in which to transact. The ARA believes that to a large extent, such a practice does not encourage retailers to truly strive for success as much of the profit from their own marketing and business acumen will be absorbed by the landlord who may not actually have contributed anything significant to the increased success. At a more fundamental level, the ARA believes that such an imbalance represents a practice which borders on unethical cartel-like behaviour.

ARA also believes that the present circumstance whereby no mechanism exists mandating the registration of retail leases with an independent, government-auspiced body, further entrenches the imbalance between retailer and landlord. Although in New South Wales there is a process for registering retail leases, the fact that there are very few penalties applied to a landlord who fails to do so and that there appears to be little policing of this requirement, is a concern to retailers.

Furthermore, retailers are often faced with onerous built in costs in their obligations as tenants. In addition to the inherent lack of certainty in any lease arrangement, retailers are often also obliged to provide a full refurbishment to their store around every five years or relocate to accommodate the shopping centre's plans for the future layout and target demographic of the whole centre.

Simply put, the ARA believes that there are issues of inequity within the retailing sector whereby the retailer assumes an enormous amount of risk, exposes themselves to market forces, complies with some of the most stringent regulatory and industrial relations policies in comparable economies and behaves largely as a good corporate citizen. Large shopping centre landlords however can, and do, squeeze retail businesspeople, often mum-and-dad companies, with little oversight by an independent regulator or equitable transparency to the other party in negotiation.

Tied to this point, and indeed perhaps empowered by the lack of registration requirements, there exists a degree of ambiguity in negotiations whereby a prospective or incumbent tenant has little to no transparency of what "off-the-books" deals may have been agreed to by other parties. For example, although the rent per square metre, rental percentage, and length of lease may be comparable, or indeed identical, one retailer may have been given an incentive (such as additional marketing, fit-out, or other amenities) creating preferential treatment of certain tenants over others.

Retailers are forced to transact in this landlord-defined marketplace because there are very few practical alternatives available to them. Where a general retail shopping centre is permitted, there is invariably an exclusive zoning which excludes any further development of a competing shopping centre in a similar area. As such, the existing shopping centre is granted an effective monopoly on the marketplace for consumers wishing to shop from a shopping centre in that area. It is a false assumption to think that a shopping centre retailer can choose to relocate out onto the strip in the same area if they don't like the centre operators. Invariably, the retailer is forced to meet the Shopping Centre's terms because retailing from the outside strip is simply not commercially viable and any relocation will almost certainly realise the failure of that business. Shopping centres generate traffic flow, combined marketing, parking and entertainment which a local shopping strip or mall generally does not provide. For a retailer to 'exit' a shopping centre requires a change in their entire operations of the retail business and usually is not compatible with the existing retail style.

The effect of this on retailers is that real rents have soared above inflation, with rents commonly set at CPI + 2% per annum during the lease, and then being increased by as much as 30% on top of those

already compounded CPI increases at the end of a lease, simply because the retailer has nowhere else to go and must accept the rental or risk peril outside on the strip.

An example of where competition in shopping centres has effectively opened up the market place and reduced rents is in the area of Bulky Goods Retailing or more commonly recognised as 'Homemaker' centres. These 'shopping centres' have sprung up in the last 20 years or so by using the zoning exemption for goods retailed under a Zone 4B planning exemption, which was traditionally used for factory warehouses selling their products from their own showroom within premises used to manufacture those same goods. Hence under this zoning exemption, many new shopping centres have been constructed by new players in the shopping centre marketplace, and created an alternative competitive force to traditional shopping centres. An example of this is the Moore Park Supacentra in Kensington, a suburb of Sydney which has successfully developed in opposition to Westfield Bondi, Westfield Eastgardens and the many centres in the Sydney CBD. Additionally, upon the huge success of the Moore Park Supacentra, many other developments have occurred in the nearby suburb of Alexandria including the 'Style at Home Centre' Alexandria, Domayne Centre Alexandria, and the Harvey Norman Centre Alexandria. Each of these reflects a shift in ownership away from the larger traditional shopping centre owners, and an alternative location for any retailer wishing to relocate. There has also been a correction in the rental rates for Bulky Goods centres as competition has driven automatic rental increases to halt and retract in recent times.



## **Other challenges of doing business**

Retailers in Australia are finding that the cost of doing business is increasingly onerous. Although a high Australian dollar is good for both consumers and retailers in terms of purchasing goods for a better rate from overseas, in the quantity they are purchased by retailers and the associated supply and manufacture costs built in to the unit price, along with rising wage prices in manufacturing economies, the higher AUD can perversely drive operating costs higher for retailers. Obviously, with consumer spending being pulled offshore because of the near float-high value of the AUD, this provides a pronounced challenge to retailer profitability.

A combination of the factors shown in the previous section of this submission is compounded by the relative disadvantage that retailers have in bargaining for the retail space and the disadvantage a retailer finds themselves in when attempting to renew an existing lease due to the alternative of relocating their business being a costly, if not terminal and unviable alternative. As such, the occupancy cost of Australian retailers (being the cost of the tenancy as a percentage of turnover) is reported publically by Australian Shopping Centre landlords as being on average between 18-20% of turnover, and which is almost double what the occupancy cost is in the USA for similar tenancies. This disproportionately high cost to simply do business, presents an incredibly profound challenge to retailers and is no doubt a key reason why the Australian retail sector is struggling structurally.

It must be stated that the requirement for retail businesses to comply with the Federal Government's Award Harmonisation process also places an added challenge to retailers as employers. Although the ARA do not propose in this submission to comment on what has been decided by the Parliament and the community on what represents fair workplace policy, the application of this does pose an additional problem to retailers. Specifically, the rising cost of labour required through Fair Work Australia does act as a disincentive to retailers to retain its relatively low-skilled workforce at a time when trading conditions are incredibly slow. Moreover, the productivity of workers in retail does not necessarily line up with the award harmonisation policies at a category-by-category level and, simply put, Australian retail is yet to show any signs of a sustained recovery. Australian Bureau of Statistics figures for March<sup>2</sup> have shown turnover fell across the retail sector. In department stores (-3.0%), Food retailing (-0.4%), Household goods retailing (-0.3%), Other retailing (-0.1%) and Cafes, restaurants and takeaway food services (-0.1%). Turnover did however rise in Clothing, footwear and personal accessory retailing (0.1%). This lagged recovery is compounded by Australian consumers being unable to accept, either fiscally or philosophically, any rise in retail prices to the detriment of retail viability as well as being faced with rising cost-of-living pressures which severely reduce discretionary spending.

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<sup>2</sup> Australian Bureau of Statistics, Report 8501.0 - Retail Trade, Australia, Mar 2011

Retailers as employers are also challenged through the comparatively higher wages in other sectors, even for unskilled workers, acting as a pull factor and providing challenges to retention and new employment. The perennial anecdotal examples of unskilled labourers and support personnel being offered enormous salaries in the mineral or energy sectors continue to abound and, in the comparatively low-margin, high-volume model of Australian retail, this is not something retailers can compete with.

Indeed, one of the biggest complaints by Australian consumers is that retailers in Australia work off high margins and the inference is that Australian retailers are price gouging when compared to international retailers. The reality is that Australian retailers work off higher gross margins in order to cover their costs of doing business in Australia.

Typically, a retailer in Australia may mark a product up by at least 100% on its cost to market its selling price. A similar retailer in the USA may only mark that same product up by 50% and in the UK by 75%.

However, it is the net profits of retailers which indicates the true picture, where the average Australian retailer makes a net profit of only between 2% - 8% of turnover. Depending on the sector of retail industry, this tiny profit margin reflects the high level of costs borne by Australian retailers in doing business domestically, and which, in comparison to the international retailer, is less than comparable.

This point clearly indicates why a low value GST and customs exemption on foreign products purchased online (amounting to 15-20% of the price) is so damaging to the Australian retailer, as they cannot sustain discounting below 2-8% in the long run and hence cannot compete. There is also no ability to restructure their operations to compete against international retailers due to the heavy costs of taxation and compliance.

Moreover, retail continues to suffer from a perception that it is neither a stable nor family-friendly work environment. Largely, this is due to the inherent nature of shift-based work, high levels of casualisation and, even for permanent employees, the risk that small retailers may have to close down for lack of profitability.

In terms of compliance with relevant laws and regulations, retailers in Australia suffer from the pluralistic frameworks associated with our multi-jurisdictional society. From a local government perspective, retailers need to pay Council rates and taxes, rubbish and packaging removal fees, signage license fees, parking contribution levies, and many outgoings which are hidden in the disbursements of their 'Shopping Centre Outgoings' levies.

Similarly, from a state government perspective, retailers pay payroll tax, Workers compensation premiums, stamp duties (where still applicable), Fire Service Levies, registration and licence fees for business operations, motor vehicle related taxes including road taxes generally paid through their suppliers, distribution and logistics providers, but reflected in the cost of the goods.

From a federal government level, retailers pay income tax, capital gains taxes, GST, FBT, property taxes, staff Superannuation, Pay as You Go withholding tax, ASIC registration and compliance fees, Customs duties, a potential Carbon Tax, and so on. These regulatory burdens can be furthered compounded for larger-scale retailers who operate on a cross-jurisdictional basis, and do account for lost time and non-core business administration.

The final compounding factor on this is the huge expenditure that Governments are currently putting into Bushfire reconstruction in Victoria and flood reconstruction in Queensland, New South Wales, Victoria and South Australia. Such work will require an enormous amount of labour, which for the aforesaid reasons poses a challenge to retail employers, but will also put a drain on tradespeople for building new retail premises and providing refurbishment services to existing sites and drive up price.

Australian retailers face considerable challenges in simply getting their goods to market which, arguably, are not replicated in comparable economies. As retail in Australia is predominantly an import-dependent business, structural impediments are felt as a result of Australia's comparatively low position in the international supply chain as the proportion of the international market for imports into Australia is not significant. This often results in the orders of Australian retailers and wholesalers, particularly for specialist consumer goods being placed at the end of the queue by overseas manufacturer suppliers. Australia's access to the supply chain is often limited by the size and scale of our domestic retail industry and also results in increased wholesale prices imposed by suppliers in the country of manufacture which is an additional price point which needs to be factored in for the Australian consumer, compared to a product exported to a larger economy, such as the United States.

Australian retail is also being detrimentally impacted by natural disasters around the world. Most recently, Japan has experienced economic instability as a result of the earthquake and tsunami. Consequently, this has resulted in a price spike for consumer products manufactured there and this has had a pronounced effect on supply chain reliability with Australian retailers facing delays in obtaining products. Larger markets are able to secure products sooner than Australia leaving domestic consumers with no option but to source these particular products from offshore online sellers.

### **Offshore online channels**

The ARA is a member of and Secretariat for the Fair Imports Alliance (FIA) and endorses the views put forward in that organisation's submission to this inquiry dealing with matters of the inequitable application of taxation policy to Australian domestic retailers compared with overseas online retailers. This inequity comes about through offshore retailers selling direct to Australians, principally via the internet, and, in many instances by-passing GST obligations as a result of a legislated low-value importation threshold exempting goods of less than \$1000.

A crucial impediment to Australian retail business is this misapplication of GST thresholds which has the net effect of automatically providing a 15-20% (that is, 10% GST and 5-10% duties) advantage to offshore retailers over Australian retailers selling the same product.

This creates an effective impediment to trade for Australian retailers who are already struggling to drive and grow their businesses. For the purposes of this submission, the ARA will not elaborate further, however supports all points raised within the FIA submission.

## Policy Recommendations

The ARA wishes to advance some potential policy outcomes which would greatly lessen the impact of these challenges. Key to this would be mechanisms to redress the imbalance between landlord and retailer. As noted earlier in this submission, retailers in shopping centres face several challenges in particular reference to tenancies. In order to ease these concerns, the ARA proposes the following recommendations:

1. *Current rental standard practices imbed a systemic power imbalance...*

To completely remove the perception, and actual instances of predatory negotiations by landlords calibrating percentage rental obligations and minimum rent clauses based on specified knowledge of business activity through an abuse of the “Turnover Rent” provisions. Third party aggregation by channel of sales data could be incredibly advantageous. In practice, such aggregation could be achieved through either using ABS data or, perhaps more uniformly, the centre-defined retail channels on all internal directories (for example, electronics, men’s clothing, medicinal, and so on). To ensure fairness, a figure could be set where a concern over a notional variance, for example 3%, would require an independent accountancy audit. Such a reform would mean that landlords would have to calibrate their rental increases more generally, however would still provide a mechanism for ensuring mutual transparency and fairness in deriving a return on investment, whilst still allowing commerce to flourish
2. *Certainty of tenure...*

Existing tenants in shopping centres, who are not given the option of a new lease, should be offered both the first and last right of refusal to re-lease the premises prior to the landlord executing a lease to another tenant for the site. This will ensure that the landlord does not manipulate the existing tenant into a higher tenancy rate by alluding to the threat of an alternative retailer wishing to move in.
3. *Independent market valuation of rent...*

An existing tenant should be able to seek an independent market rental valuation of their tenancy as a condition of entering into a new lease, particularly as there is not currently a market rate for commercial tenancies. In line with the NSW Retail Leases Act (under s.31), this mechanism would reflect that specific market valuation at the commencement of the subsequent lease. In addition, if neither party can agree on a rental rate, there should be a mechanism whereby a specialist retail valuer appointed by the Registrar or the Minister of the relevant jurisdiction, can determine the rate as part of such an expansion to their statutory authority. These two procedures would prevent the landlord from simply using a retailer’s turnover figure to determine the re-negotiated rental rate.

4. *Reform of holding over provisions...*

During the 'lease holding over' period, the base rental payable should be discounted or adjusted as a concession to the retailer for their lack of security of tenure.

5. *Mandatory registration of rental leases...*

Finally, the ARA believes that a similar model to that of NSW should be adopted whereby a registration of retail leases is recorded with an appropriate regulator. Ideally, such a matter will be given appropriate powers to police non-compliance and would be harmonised across jurisdictions.

## **Conclusion**

The ARA understand that the retail sector is faced with enormous challenges which are in the main external from any matter the Productivity Commission or indeed Government can directly address. However, the fact that the retail market is continuing to contract and the increasing prevalence of online distribution channels along with retail tenancy arrangements that are all but predatory is not a sustainable marketplace going forward. The ARA believes that Government can take indirect steps to limit the capacity for cartel-like behaviour among market-dominant shopping centre owners and provide a degree of regulatory streamlining to better foster productivity in the sector.