

18 July, 2007

Retail Tenancies Inquiry  
Productivity Commission  
PO Box 80  
Belconnen ACT 2616

Dear Sirs,

Attached is our submission relating to The Market for Retail Tenancy Leases in Australia.

Our company is a privately owned limited liability company conducting a retail footwear business from 19 leased sites in Sydney, Melbourne, and Brisbane. Our leased retail sites include:-

- new 1<sup>st</sup> term leases
- renewed leases
- assigned leases
- sites in strip shopping premises owned by private individuals, as well as sites in major shopping centres operated by Australia's largest shopping centre management companies
- sites with quite low rental costs per square metre, right up to super-prime sites in Sydney's Pitt Street Mall with per sqm rental costs in the top 10% worldwide.
- leased areas varying from 49 sqm up to 230 sqm.

We are well positioned to provide an experienced and considered submission from the perspective of a small to medium sized retail operation.

Our submission will primarily deal with the key issue of lack of real competition, and the consequent imbalance in relative bargaining power. We then make submissions which address the flow-on topics of Lease Guarantees and Lessor access to tenants' turnover figures which both stem directly from this lack of competition.

Sincerely,

Peter Pitt  
Director

**HYPE DC PTY LTD** ACN 081 432 313, ABN 16 081 432 313

**NSW:** 666 Military Road, **Mosman**, 4 The Corso, **Manly**, P58, Imperial Arcade, Pitt St, **Sydney**, 320 Victoria Ave, **Chatswood**, Shop 15 Galleria, 74-78 The Corso, **Manly**, Cnr. Pitt St Mall & Market St, **Sydney**, Shop 18 Pittwater Place, **Mona Vale**  
Shop 50 Queen Victoria Building, 455 George St, **Sydney**, 304 Oxford Street, **Paddington**, Shop 3055b Westfield **Bondi Junction**,  
Shop 10.12 World Square Cnr Liverpool & George Sts, **Sydney**, Shop 4062 Westfield **Parramatta**,  
Shop 366 Westfield **Chatswood**.

**VIC:** 373-375 Chapel St, **South Yarra**, 253-267 Bourke St, **Melbourne**, 76-78 Bridge Rd, **Richmond**, QV Centre Swanston St, **Melbourne**

**QLD:** Shop GF14 Broadway on the Mall, 170 Queen St Mall, **Brisbane**,

[www.hypedc.com](http://www.hypedc.com)

fax: 02) 9264-7639

All Mail to:

**Level 6, 192 Pitt St Sydney 2000**

## **Low competition – brings a lack of Relative Bargaining Power**

### **Circumstances that lead to low competition.**

Despite the legislative improvements of the past 10 years (Reid Report 1997, Trade Practices Act amendments of 1997 and 2004, etc, plus the many amendments made at State level) there remains a massive imbalance of bargaining power between lessor and tenant in retail lease negotiations. Below are some of the reasons / evidence:-

- ***There's no competition unless it's simultaneous competition!*** When seeking a retail site in a suburban street location it is very rare that equally prominent sites, of a similar size, in a similar location, all become available at the same time in order to create genuine competition between lessors. Simultaneous real competition between multiple lessors can happen and does happen, but this is very much the exception rather than the rule – *especially in the most sought-after locations*. Almost always these sites become available one at a time in different months or different years. Each lessor therefore can usually negotiate simultaneously with a number of prospective tenants who are all interested in that one lessors' site, but those tenants have just one single lessor (on each occasion) with whom they may deal. The result is a significant imbalance of bargaining power.

Some people will argue that competition between lessors exists for leased sites in strip centres because each tenant can always “decline” the terms offered by one lessor and wait for the next opportunity from the next lessor, of similar size, in a similar area, and with similar prominence. Such argument overlooks the fact that if and when the next opportunity comes along the lessee will at that time have to, yet again; negotiate with just one single lessor in a situation where the tenant suffers an imbalance of bargaining power.

- ***There's no competition in market-dominant major shopping malls!*** The situation is even worse in major shopping malls. In many locations, shopping malls have reached monopolistic market-dominant positions.

Two random examples would be the Chadstone and Highpoint shopping centres in Melbourne. Chadstone dominates the south east suburbs and Highpoint dominates the northern suburbs.

In the areas surrounding both Highpoint and Chadstone shopping centres there is no viable “strip” shopping alternative where a retailer could seek to lease a site. There is just a massive sprawl of suburban houses surrounding a gigantic shopping mall. If any retailer wants to effectively service consumers in the northern suburbs or the south/eastern suburbs then that retailer has no choice except to negotiate with the owners of Highpoint or Chadstone, respectively.

The same market-dominant positions exist with major shopping malls in many other Australian locations – we do not mean to imply that Chadstone or Highpoint were unique in this regard.

- ***Nothing demonstrates the imbalance of bargaining power more effectively than the rent differential between majors and specialists.*** It's common in major shopping malls for department stores, discount department stores, and supermarkets to pay rents per square metre that are one tenth of the rate paid by the hundreds of small specialist shops in the same mall.

Lessors' justify this on three primary factors:-

- 1) The centre wouldn't have been built without signing the major tenant
- 2) The major tenant leases thousands of metres
- 3) The major tenant "attracts" lots of shoppers to the centre

The reality is that the 10:1 rent differential arises purely because the major tenant is in a strong negotiating position when entering into lease terms and the small specialist shop is not. Each of the lessors' justifications for a 10:1 differential can be turned 180° and using the same numbering:-

- 1) The centre wouldn't have been built without the 100's of small specialist shops because if the lessor had to rely only on the rental paid by the major tenant the project would not be feasible
- 2) The 100's of small specialists together lease thousands of metres
- 3) The 100's of small specialists together "attract" lots of shoppers to the centre

If the lessor had to negotiate the lease terms for a new centre with all specialist shops as a single group there would not be a 10:1 rent differential between major tenants and specialists.

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## **Implications of lack of real competition.**

Australia has already seen the implications listed below arise from an imbalance of negotiating power. These will simply get more prevalent with time. An imbalance in bargaining power between lessor and tenant has led to:-

- Tenants have to agree to high rental cost relative to sales. This leads to a push for higher gross margins in order to meet the higher rental cost. Retailers increasingly turn to “vertical” (“own-brand” product direct from factories) business models to achieve higher margins. As a result, consumers are offered less choice, less “global brands”, and often receive poorer quality product relative to price.

In Sydney’s Pitt St Mall only two shops (Hype DC and General Pants) still sell globally branded footwear and apparel. All the other shops sell own-brand merchandise.

Shopping centres increasingly become “the same” – with the same names of the same vertical retailers appearing in every centre.

- An imbalance of bargaining power leads to “ability to pay” pricing. Jewelry shops are charged far higher rentals than other shops because the lessors’ are aware that jewelry shops achieve very high gross margins. When lessors know their tenants sales figures then rents (especially on renewal) are increased to the lessors’ estimate of the tenants “ability to pay”. Sites are priced not on what the space is worth but on what the tenant can pay (see submission below titled “Keep sales figures secret”).
- Lessors’ obtain lease conditions that would be rejected in circumstances of real competition – like demolition / relocations clauses, lack of option terms, provision of personal guarantees and bank guarantees (see submission below titled “Outlaw guarantees”).
- Option terms in retail leases (especially in major shopping malls) are rare. This leads to tenants being in a position where they have invested in fit out, invested in advertising, and invested years of work in creating a business and building goodwill in a certain location – but cannot continue beyond their initial term unless the lessor decides to offer a new lease, and the tenant agrees to whatever terms are offered.

**Recommendations.**

We can think of no effective ways to increase competition between lessors. However, if the ACCC will at least act to prevent further concentration of ownership in major CBD locations that will at least stop matters becoming worse.

In the absence of effective ways to increase competition it would seem appropriate to at least legislate to prohibit the worst implications stemming from this imbalance of bargaining power. Our recommendations for legislative changes are:-

- **Right of continuum** - A provision to the effect that nine months before expiry, lessors should be required to offer a sitting tenant a new lease for the same period as the expiring term. Exception would be where the lessor has applied for and received a ruling from the Dept of Fair Trading, after showing reasonable grounds, for not providing a new lease.
- **Cap on market valuations** – A provision capping the rent increase payable upon renewal or upon a “market valuation” at no more than three times CPI.
- **Keep sales figures secret** – (see following pages) A provision prohibiting lessors from requiring tenants to disclose to the lessor the sales turnover they achieve.
- **Outlaw guarantees** – (see following pages) A provision prohibiting lessors from requiring retail leases to be secured by bank guarantees, cash bonds, and / or personal guarantees.

### **Keep sales figures secret**

#### **What's the problem?.**

Major shopping centres require tenants to supply monthly and annual sales figures. The requirement to supply sales figures is usually justified by:-

- 1) **Percentage rent** - Many lease agreements provide for the tenant to pay "percentage rent" in addition to rent. The lessor collects sales figures so that percentage rent can be calculated.
  - a) Note that this is yet another example of lessors' charging rent according to ability to pay - rather than by what the space is worth. The percentage rent system allows a lessor to receive higher rent from more successful retailers. Two same-size similar shops side-by-side should be paying the same rent - if one of the two shops has a higher turnover than the other this should not lead to them having to pay an extra rent expense.
  - b) In some situations percentage rent is a useful tool allowing some retailers to minimize their risk. Their view is "we can pay \$X minimum rent, and if this centre succeeds to bring in lots of extra traffic and we get sales higher, then we are happy to pay a bit more rent".
- 2) **Measuring performance** – many shopping centres claim the reason to require the provision of sales figures is so that they can monitor the commercial performance of the centre. Whether sales across the whole centre are up or down, whether certain categories are up or down, whether certain marketing campaigns are working or not – all can be measured to some extent by collecting sales figures from all tenants.
  - a) However, all this same turnover information could be collected by an independent accounting firm. The independent accounting firm could then feed back all the required sales information in total and by category whilst still keeping confidential the sales information of individual tenants.

When lessors have access to tenants turnover information rents over time are increased to the limit of the tenants' ability to pay.

Lessors distribute information to their leasing staff that shows centre-by-centre what sales individual retailers are achieving, what rent-to-sales ratio each retailer is paying in each centre, etc etc – it's pretty easy to see that if leasing staff know what is the highest rent to sales ratio a retailer is paying elsewhere, and they know what sales you are doing in his centre, then the lease renewal offer will be pitched at, or just above, the highest rent / sales ratio elsewhere.

#### **Recommendations.**

Legislation should be amended to:-

Prohibit clauses in retail leases that require the provision of turnover figures, or require any percentage rent provisions.

Where retailers wish to enter into percentage rent arrangements, it should remain possible for lessors to require turnover figures.

However, it should become an offense for any lessor to coerce or in any way insist on a lease that includes percentage rent provisions and / or the provision of turnover figures.

Retail Leases Acts should be amended to provide that lessors may direct tenants to provide monthly turnover figures to an independent accounting firm appointed by the lessor. It should be an offense for any party employed by the independent accounting firm to release any confidential sales information about individual retailers.

## **Outlaw guarantees**

### **What's the problem?.**

The imbalance of bargaining power between tenant and lessor has led to retail leases commonly including a requirement for the provision of guarantees. These guarantees can be any combination of the following:-

- Personal guarantee/s, (usually unlimited, joint and several)
- A cash bond for a sum of money
- A bank guarantee for a sum of money

Many people see nothing wrong with lessors of retail premises seeking and obtaining guarantees of various sorts to secure the tenants obligations under the lease. In fact, there is a great deal that is wrong with these guarantees:-

**Preferential** - Lease guarantees put lessors in an entirely unfair and preferential position verses the many other trade creditors a retailer may have.

In a typical month our company owes \$20,000 to our average lessor, (who gets paid in advance at the beginning of the month). That average lessor is holding personal guarantees and bank guarantees.

In the same typical month our company would owe \$1 million or more to our top one or two footwear suppliers (who get paid after delivery, giving credit terms of "current month plus 30 days") and has no personal guarantees, no cash bond, no bank guarantees.

Why would a trade supplier of footwear extend credit of \$1 million to us without guarantees, when lessors (who are owed a 50-times lower amount) have the benefit of guarantees? The answer is that there is a lot of simultaneous competition between footwear suppliers to sell us shoes, but there is rarely any simultaneous competition between lessors to rent us retail space. If footwear suppliers insisted on guarantees we would buy shoes from another supplier. But if we want a retail site in (say) the northern edge of Melbourne then there is only Highpoint Shopping centre with whom we can negotiate - and if we want the site they will get some form of guarantee.

In the event of insolvency, lessors can draw on the guarantees they hold and receive funds denied to other unsecured creditors. Critically, even employee entitlements and the tax department are in a less preferential position compared to lessors holding guarantees. Lessors' should have to accept a reasonable and balanced commercial risk just like any other unsecured creditor.

If an insolvent retailer ran off to Brazil they can take the tax departments money, they can take a shoe suppliers money. But they can't take the shop! The lessors' assets are the real estate itself and that's not going anywhere. All the lessor stands to lose is a couple of months rent which is a tiny amount compared to trade creditors, employees, and the tax department. If the premises concerned are good retail premises the lessor will have a replacement tenant signed up within a short period anyway.



**Guarantees are expensive.** Both cash guarantees and bank guarantees use up working capital. The opportunity cost of having this working capital tied up is immense. We estimate that the annual opportunity cost for our company is close to the face value of the guarantees involved because the shops we could have opened, if the funds were available for expansion, would on-average produce gross contributions equal to the total sum tied up in guarantees.

These lost shops that we can't open means that the State and Federal Governments are worse off too. More shops would mean more employment, more PAYE tax, more payroll tax, more company tax, more GST.

**Recommendations.**

Legislation should be amended to:-

Prohibit clauses in retail leases that require the provision of personal guarantees, cash bonds, and / or bank guarantees

Where the lessor has provided a capital contribution for fit out costs or other form of incentive (like rent-free periods) then the lease should require that the tenant provide the lessor with a cash or bank guarantee to the value of the incentive. This guarantee however should expire when the tenant has paid rent to the same value as the incentive provided.