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SUBMISSION: “*The Market for Retail Tenancy Leases in Australia*”

Firstly, I would like to commend the former Treasurer, Mr Peter Costello, for establishing this review by the Productivity Commission. While it is both long over due and perhaps only a starting point the efforts undertaken by the Commission to date, as highlighted in the Draft Report, are comprehensive and have clearly uncovered some areas for improvement that will be a positive for all industry participants involved.

The many submissions made, and the extensive individual business and industry consultation undertaken has clearly highlighted to the Commission several major and many minor issues which continue to prevent a truly effective market from operating.

No doubt you have also been exposed to some of the emotion and colour which characterises a market comprising of such a large and diverse number of participants as the retail industry does. In short, there is no simple answer, no single solution to a situation which has been allowed to perpetuate for more than twenty years.

As a short history my involvement in the retail property industry in Australia extends for nearly fifteen years and in multiple capacities. During this period I have operated as a representative for Managing Agents, for Landlords and also for Tenants, as both an employee and as a business services provider. Currently I am the CEO at Synetek Systems, a software company which owns and operates the LeaseEagle® Retail Lease Management solution and a founder Governor of the Australian Chapter of the National Retail Tenants Association (NRTA).

In Making this submission today there are three key points that I will address, resulting from my review of the Draft Report delivered by this Commission:

1. Compulsory Registration of Retail Leases

That whilst the registration of all retail leases in Australia will have an initial 'ooh-ah' effect there will be no mid-to-long term advantages for any participants in the retail market or for the operation and efficiency of the market for negotiating retail leases.

2. Improved Disclosure and Availability of Information by Landlords

In reviewing the 'information imbalances between small tenants and shopping centre landlords in lease negotiations' attention must be given to ensuring the accuracy, detail and appropriateness of disclosure by Landlords and the ability for tenants to obtain their own independent information.

3. Removal of Percentage Rent Review 'Ratcheting'

Whilst the application of Percentage Rents is and should be as a result of market dynamics consideration should be given to these provisions in the context of them being an annual adjustment to rent paid for a premises, and that the same restrictions against the 'ratcheting' of Rent Reviews should also apply to Percentage Rent clauses.

Compulsory Registration of Retail Leases

The registration of all retail leases in Australia is in contrast to what should be any business's right in the market, to be able to conduct business with a degree of autonomy and as appropriate confidentiality. Despite probably providing an initial voyeuristic-like response from the market this approach will have deliver no mid-to-long term advantages for any participants in the retail market or for the operation and efficiency of the market for negotiating retail leases.

A Retail Lease is defined a commercial agreement between a Lessor and Lessee for the occupation of a Retail Tenancy, as per the various definitions. As a commercial agreement entered into by two or more parties it is difficult to argue that, notwithstanding market-power imbalance, any party was forced to sign the agreement.

How could it be the Commissions' view that the highly competitive nature of the Market for Retail Tenancies in Australia warrants a different level of disclosure for Retail Tenancy Agreements, than for say Employment Contracts, Supplier Agreements, Office Leases, Contractor Agreements or pray tell Software Licence Fees?

As an arm's length commercial agreement all parties negotiating Retail Leases will benefit more greatly from operating in a secure and confidential environment.

Beyond the overriding confidentiality issues of such 'undies and all' disclosure that would result from compulsory registration of Retail Leases its implementation would still not deliver advantages for the market and its participants due to four primary reasons:

1. Each business within a retail tenancy is a profit centre that fundamentally has a level of affordability, determined by the Tenant's business model and management skill. In association, a Landlord will have a required income level that is unlikely to be affected by comparative rentals alone.

Simply gaining the knowledge of what another company's rentals will have no direct impact on whether a tenant can afford the tenancy. Operational capabilities and competitor demand are more likely impacts on a Tenant's decision.

To highlight the point:

A 'candle-stick' maker operating from 50 square metres is paying \$500 PCM and discovers that the other 3 similar size shops near to him are paying \$450 PCM, \$600PCM and \$700PCM. There is no advantage for the Tenant in knowing this and the reality is that if threatened by a competitor for that sight the Tenant is more likely to stretch its capacity to pay the commercial terms, and avoid giving a competitor an advantage.

Equally for a Landlord, gaining the knowledge of other Landlords' commercial arrangements with Tenants is most likely to be used to increase average base rentals not reduce rental levels to meet the lowest common denominator.

The only instance where this level of external or market knowledge is beneficial is during the negotiation of market rent reviews, a commercial rarity. In any event, those Valuation Professionals appointed to determine these rents already gain access to this information to make their valuations and as such any market benefit would be minimal.

2. It cannot be guaranteed that a Retail Lease contains the entirety of the commercial relationship between a Lessor and a Lessee(s), hence relying upon it as a complete body of evidence is not possible.

As it currently operates in those States in which compulsory Lease Registration is enacted Landlords simply provide Tenants with a supplementary non-real estate commercial contract that is used to separately document any incentive provided to the Tenant to take possession of the tenancy.

With regulation or legislation unlikely, and rightly so, to restrict the entirety of commercial relationships between parties there can be no guarantee that the details for the Registered Lease are a complete representation of the total cost of occupying the tenancy, hence actually misinforming the market.

3. Any real dollar benefits gained by those Lessees who are not as capable of negotiating commercial agreements will be offset by negative outcomes for those tenants who have negotiated favourable commercial terms, relative to the market.

A Tenant's ability to negotiate a favourable Retail Lease is primarily guided by its Professional Capacity, Competitive Advantages and the level of demand the Landlord has for the Tenant.

It would be highly rare for a Landlord, who knew all of the Tenant's Lease information as a result of the lease being registered, to reduce the income for his/her investment. In fact, it is almost a certainty, that any registered leases with higher rental levels will be used as the new benchmark, to increase investment income.

Subsequently and perhaps not surprisingly whilst both parties might be keen to see information from Registered Retail Leases there are no guarantees that this in any way will reduce rental levels and/or improve the fairness, speed or complexity of negotiating a Retail Lease.

4. As is currently the case, the creation of additional 'registration' fees, applied as a duty or levy for the registration of the Retail Lease will be directly or indirectly recovered from the Tenant, and consequently consumers.

Whilst the monetary cost applicable to Lease Registration would be considered small it would no doubt be passed on to the Tenant and ultimately the consumer, as it already is in Qld, NSW and ACT.

A medium sized retailer would usually negotiate 50 – 80 lease renewals and new leases in an average year. A registration fee of \$300 would impose an additional cost for this business of between \$15,000 to \$24,000 per year, contributing to State or Federal Government revenues but delivering nothing but additional expense for retailers.

Improved Disclosure and Availability of Information by Landlords

In reviewing the 'information imbalances between small tenants and shopping centre landlords in lease negotiations' attention must be given to ensuring the accuracy, detail and appropriateness of disclosure by Landlords and the ability for tenants to obtain their own independent information.

It is certainly true that an information imbalance, as coined by the Commission's Report, exists for many retailers and shopping centre Landlords. In determining the appropriate future course of action the Commission should include the following questions in reviewing Landlord Disclosure?

1. Is it appropriate that a Billion dollar multi-national landlord with a 100,000 square metre complex comprising 400 tenants be only required to provide a similar level of disclosure to an elderly lady who has a single 100 square metre shop a local retail strip?
2. Is what Shopping Centre Landlord's are currently required to disclose helpful to retailers in their making of commercial decisions regarding retail tenancies?

3. If extended to standardised performance measurements would Shopping Centre Landlord's provide accurate Disclosure information and how would this be monitored, audited and if required penalised?
4. How can Tenants be more able to develop their own independent view of commercial opportunities presented by Shopping Centre Landlords?

Question No. 1

A clear distinction of the difference between shopping centre Landlords and a retail tenancy landlord needs to be made. The current concentration of shopping centre ownership in Australia means that most Landlords are very large listed companies that have access to thousands of comparative tenant records. The performance of the shopping centre, the management company and the Landlord and have a direct impact on almost all tenants.

Whilst combined, retail strips are the largest sector of retail property, Landlords of these premises are essentially small private investors with little day-to-day engagement with the property. Outside of keeping the property in good repair any operational input these Landlords or their Agents have has no impact on a Tenant's performance.

A broad definition of Shopping Centre would comprise a major tenant, even a single supermarket, and a number of smaller specialty tenants. Given average size ranges my submission is that a Shopping Centre be defined as being larger than 5,000m² in size and have at least one major tenant of minimum 2,500m². While there will be a vast range of property sizes beyond this point it is my professional opinion that at this point the impact of the Landlord and the shopping centre on a Tenant's performance can be significant.

Whatever the definition of Shopping Centre, in the development of a Compulsory Code of Conduct for Shopping Centres, strong consideration should be given to placing greater requirements on the Landlords to provide information to prospective and sitting tenants with regard to the current and recent performance of the centre. Given the greater potential for the impact of the centre on a Tenant's business Landlords must be held to account in this regard.

It would be more advisable to include such requirements in a mandatory Code of Conduct for Shopping Centre Landlords than to amend State-based Disclosure Statements, which are likely take longer and impact all Landlords, not just those of shopping centres.

Questions 2

Currently the level of Disclosure required by Shopping Centre Landlord's is grossly insufficient. The number of car parks a centre has, the number of square metres it is, the budget for outgoings, the number of food-court seats is not granular and important enough to impact on a

Tenant's commercial tenancy decision, and in any event is information that a diligent Tenant could obtain themselves.

When the level of investment on rent, employment, stock purchases and other expenses are tallied even small Retail Tenant's are making 'million dollar' decisions, with very little real understanding of how the Shopping Centre, and the immediate precinct within the centre, are performing.

Most tenants are flying blind or using some maverick-style 'gut feel' regarding site selection and commercial deal analysis. As part of this submission it is my view that allowing retail tenant's to know what rents are being paid for similar shops does nothing to help them make a decision on what is affordable for their business.

It should be about helping them to make faster, more educated decisions regarding business performance and affordability than a blanket comparison of all fashion shops from Booragoon to Banyo.

Is what Shopping Centre Landlord's are currently required to disclose helpful to retailers in their making of commercial decisions regarding retail tenancies?

No. The size and sophistication of Shopping Centre Landlords and their management companies, and the impact that they and the performance of their asset can have on a single retail tenant, are key reasons why these groups should be required to provide more detailed and valuable information regarding the performance of their centres, to the retail tenants making million dollar commercial decisions.

In order for Shopping Centre Landlords to provide improved disclosure to retail tenants the following measures should be considered by the Commission:

Tenant Sales Productivity – The average turnover per m² for the shopping centre, speciality tenants, major tenants and retail trading categories in the centre, including variance to the previous 1 to 3 years.

Sales Value – The total turnover for the shopping centre, specialty tenants, major tenants and individual retail trading categories in the centre, including variance to the previous 1 to 3 years.

Traffic Count – The average weekly pedestrian count, by hour, for each entrance of the centre, including variance to the previous 1 to 3 years.

Store Rankings – The current sales ranking of traders in the appropriate retail trading category, and the relative sales ranking of adjacent tenancies in their retail trading category.

Although not to be an entire list of options at least these performance metrics are ones which the majority of Shopping Centre Landlords already collect and produce, but do not disclose, other than "off the back of a truck" to a well known retailer or leasing consultant.

Importantly, this level of detail regarding centre performance would allow prospective tenants better information to make faster and more informed evaluations of the competitiveness of the centre, the trading performance of the immediate vicinity to the tenancy under consideration and ultimately the commercial viability of the opportunity.

Question 3

In enhancing the level of disclosure by Shopping Centre Landlords it would also be critical to ensure that a standardised approach to the calculation of performance metrics be established, so that accurate benchmarking and comparative analysis could be done by retailers.

If extended to standardised performance measurements would Shopping Centre Landlord's provide accurate Disclosure information and how would this be monitored, audited and if required penalised?

It has never been my experience, throughout the industry, for a Shopping Centre Landlord or its representative to maliciously provide any incorrect information. Most Landlords are not transparent in their disclosure of information due to the threat of Misrepresentation or Unconscionable Conduct cases under the *Trade Practices Act*.

With an industry developed and well documented set of measurement standards for the disclosure of shopping centre performance metrics any discrepancies in accuracy would be minimised, retailers could rely upon the information, and Landlords would be protected from litigation, assuming they were meeting the standards.

In monitoring, auditing and judging the application of these standards I believe it would not be difficult for Shopping Centre Landlords to have to submit to a KPMG or EY style annual process audit that would assess their method for calculating such metrics, ensuring due care was being taken to adhere to the industry standards and the delivery of accurate information.

Question 4

The domain of the Shopping Centre is the Landlord's, by rights it is their asset. However, as the asset is in existence due to the combination of its retailers, it could not be argued that a Shopping Centre does not benefit from better performing retail tenants. Conversely, each retailer is directly impacted by the performance of the centre and in a number instances the performance of major and even adjacent retail tenants.

Why is it that prospective tenants are not able to undertake independent reviews of shopping centre performance in developing an independent view of the opportunities in these centres?

If a Retail Tenant is considering a shop on a retail strip they are almost entirely unrestricted in their ability to undertake customer surveys, traffic counts, liaison with adjacent tenants,

photographs and any number of sensible, valuable and practical steps towards an assessment of the commercial viability of the opportunity.

However, in Shopping Centres, the vast majority of retailers are entirely restricted in independently being able to make very normal and businesslike assessments of commercial opportunities. Almost all information is filtered through the management company and approvals for any allowances to perform an independent assessment are purely discretionary and for the most part not granted by centre management.

If a company is seeking to make a 'multi-million dollar decision' on a business opportunity in opening a retail outlet in a Shopping Centre why shouldn't they be provided all reasonable opportunities to independently assess its commercial viability? Restricting this capacity is in complete disagreement with the objectives of both parties – a profitable retail outlet.

As part of this submission I propose the following types of measurement be allowed to be independently undertaken by retail tenants in shopping centres:

- Local pedestrian traffic counts
- Local customer surveys
- Adjacent retailer/tenant surveys
- Photographs

Removal of Percentage Rent Review 'Ratcheting'

The application of Percentage Rents is and should be as a result of market dynamics. Consideration should be given to the affect of these provisions in the context of them being an actual adjustment to rent paid for a premises, and that the same restrictions against 'ratcheting' of Rent Reviews should also apply to Percentage Rent clauses.

The combination of charges incorporated under a Retail Lease is for that retail business treated as a single cost of occupancy. As is standard practice this cost of occupancy is reviewed in various ways, usually in regular time intervals over the term of the Lease.

Percentage Rent, sometimes referred to as Additional Rent, is usually calculated as a percentage of that turnover which is in excess of a fixed or variable turnover threshold. A Retail Lease is likely to establish a Base Rent, sometimes referred to as a Minimum Rent, which will act as a floor price for total rent for the tenancy.

For both Landlords and Tenants the flexibility of a Percentage Rent can be an attractive method for calculating what might be deemed a fair rent. This is commonly the case in situations where the Tenant or the Premises are untried or unproven.

Most often however Percentage Rent clauses are used by Landlords to obtain sales information from a Tenant, in order to establish that entity's capacity to afford a variable rental increase during the lease or upon expiry.

It is common practice for Landlord's to implement a Percentage Rent clause as a method for receiving additional income from the success of the Tenant's business operations. Commonly there is no usually no provision for the total rent payable to reduce during the term of the Lease as the Base Rent amount is used to effectively 'ratchet' the rental.

As is the case in some of the legislation today Landlords are prevented from creating a floor price in the rental for a Retail Tenancy, ensuring that the rental for the premises can be a true reflection of the review measure – if there is deflation the rent can go down.

It is a natural progression to think that these restrictions on the establishment of a floor-price for Rent Reviews should be extended to Percentage Rent clauses, to truly provide a measure of the quality of the premises and the affordability for the Tenant.

In my professional opinion there is no doubt that this implementation would establish a fairer environment.

Summary

In closing I would make the point that the negotiation of retail tenancy agreements is always between two willing participants. Responsibility exists on both sides to approach the negotiations with professionalism, commercial pragmatism, legal authority and sufficient due-diligence. It is the responsibility of regulators and government to allow these transactions to be done in an open and fair market, and with the least intrusion.

In my opinion the level of disclosure and access to information is currently the single greatest divide between shopping centre landlords and retail tenants, which until resolved will continue to hold back this industry. Retail tenants need to be able to make better decisions, a large component of which is about having good access to the right information. A commercial decision regarding affordability still needs to be made for each business transaction.

By providing disclosure of all known commercial factors for every retail lease in Australia will do nothing but remove the skill, judgement and competitive advantage of some of Australia's best retail entrepreneurs. It does nothing for a retail tenant's ability to analyse their business model and determine whether they can afford the 'deal'.

Let business people be business people and allow commercial risk to be taken and rewarded. Just allow this to happen in an environment where these businesses can operate with sufficient information and understanding to make the right decisions for each of their individual retailing businesses.