



**A U S T R A L I A N  
R E T A I L E R S  
A S S O C I A T I O N**

**Supplementary Submission to  
Senate Economics References Committee**

**Inquiry into the effectiveness of the *Trade Practices Act 1974* in protecting  
small business**

**November 2003**

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## **1. EXECUTIVE SUMMARY**

This supplementary submission discusses the common practice whereby shopping centre landlords insist on applying a percentage rent clause to leases, which requires the tenant to provide its sales turnover figures. The landlord generally applies this clause in a way that makes it almost impossible for the retailer to benefit, and uses the turnover figures to ensure the highest possible rent is being charged.

Small retail tenants in shopping centres face a range of anti-competitive conditions, as detailed in the ARA's September submission to the Australian Senate Economics Committee's ('the Committee') review of the effectiveness of the Trade Practices Act (TPA) 1974 in protecting small business.

As described in our September submission, a mandatory code is necessary because the ARA has been unable to engage the Shopping Centre Council of Australia (SCCA) in agreeing a code on a voluntary basis.

The TPA could protect small businesses more effectively by requiring a mandatory code of practice for tenancy under part IVB, and ensuring an appropriate national body with investigative and mediation powers oversees its implementation.

## **2. INTRODUCTION**

### **2.1 The Australian Retailers Association**

The ARA is the nationwide voice of the Australian retail industry.

The ARA's membership comprises approximately 11,000 retail businesses, which transact an estimated 70 percent of the nation's retail sales and employ around three quarters of the retail workforce of 1.1 million people.

ARA members operate around 40,000 retail outlets across the nation. Approximately 10,000 or 95 percent of the ARA's members are small businesses (i.e. employing less than 20 staff) operating in only one state.

## **3. BACKGROUND**

This paper has been prepared to expand upon issues raised by the Committee during the ARA's public hearing interview.

The issues relate to the use of percentage rent clauses in shopping centre leases in Australia and compare the situation to that seen in the United Kingdom and United States of America.

The original arguments and recommendations made by the ARA in its September submission stand, and we have not sought to repeat these in this supplementary paper.

#### **4. RECOMMENDATIONS**

A retail tenancy leases code of conduct should be made mandatory under section IVB of the TPA to protect retail businesses from unfair practice, including ensuring that shopping centre landlords cannot insist their tenants sign a lease with a percentage rent clause whereby sales turnover figures must be provided.

To ensure such a code is effective, there needs to be an appropriate national body to oversee tenancy issues for smaller retailers, with investigative and mediation powers. The scheme operating in Victoria under the Small Business Commissioner provides a sound model for a national body.

#### **5. PERCENTAGE RENT CLAUSES IN RETAIL LEASES**

The Committee asked the ARA to provide further information on how the use of retail leases with percentage rent clauses differs in Australia compared to other countries.

Leases with a percentage rent clause involve a landlord charging a minimum rent plus a percentage of gross sales in excess of a fixed dollar amount.

The use of such clauses in the UK has traditionally been very limited because shopping centres are not the dominant form of retail space. The UK 'High Street' is the prime location for retail, so there is a much greater diversity of landlords and thus more competition for tenants. Shopping centres have started to become more popular in the UK in the last five or so years, and the percentage-rent clause is subsequently becoming more common.

The use of percentage-rent clauses is very widespread in Australia because shopping centres are popular.

In Australia, minimum rents are so high that the percentage rent rate is almost impossible to apply in practice. Percentage-rent clauses are used by landlords purely to access a tenant's turnover figures in order to determine the highest possible rent, which is often in excess of a tenant's capacity to realistically pay. Tenants must cut all expenses as much as possible in order to pay the rent, and this often means staff cuts are necessary or new staff cannot be hired.

The situation is very different in the US, where rents are much cheaper and thus the percentage rent model works well, offering benefit to both tenant and landlord (see Appendix B for example).

It is the ARA's view that most Australian retailers would be happy to operate on a percentage-rent basis, and thus to supply their turnover figures, if minimum rent levels were at a similar level to those in the US.

Minimum rents in shopping centres are up to 100 percent more expensive in Australia compared to the US (see Appendix A for details). This is partly because Australian planning laws tightly control the locations of shopping centres and thus

competition between centres is limited, with many retailers having little choice as to which centre they can inhabit.

**The provision of sales figures required under a percentage-rent clause gives the landlord a much stronger position at lease renewal to extract maximum rent from a vulnerable tenant, who must preserve his or her livelihood and the goodwill established with local customers.**

## **6. BACKGROUND TO USE OF PERCENTAGE RENT CLAUSES**

Leases with percentage-rent clauses have been commonly used by shopping centre landlords for many years. The concept arose out of the growth of shopping centres in the 1960s and 70s where both the landlord and the tenant were prepared to share the risks and the potential benefits of operating in a new centre.

To attract tenants to Greenfield sites, landlords would offer a low rent with a clause also requiring a percentage of gross sales in excess of a fixed dollar amount. This amount is referred to as the 'break in' figure.

For example, if an apparel store had a minimum rent of \$52,000 per annum and a percentage rent level of 10 percent, the tenant would pay 10 percent on sales in excess of \$520,000.

This arrangement suited both tenant and landlord as it gave the tenant the opportunity to increase sales while paying an acceptable rent and the landlord got a share of profits if the tenant achieved strong sales.

However, the landlord was only assured of the minimum rent, and began to increase this component as regional centres became more successful.

## **7. EVIDENCE OF HIGH RETAIL RENTS IN AUSTRALIA**

In comparing information in a study on the relationship between retail sales and shopping centre rents<sup>1</sup> with figures in the JHD (Jebb Holland and Demasi) Averages for 1995 for Australian shopping centres, we see that while productivity rates are similar for sales, the rent can vary in Australia compared to North America from 38 percent higher for jewellery to 105 percent higher for specialty apparel (see Appendix A for details).

## **8. LANDLORD INSISTENCE ON PROVIDING TURNOVER FIGURES**

Many shopping centre landlords insist their retail tenants sign a percentage rent-based lease whereby retailers must provide sales turnover figures.

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<sup>1</sup> Chun, Eppli and Shilling 'An Analysis of the Relationship Between Retail Sales and Shopping Centre Rents', Journal of Real Estate Research Vol 21 Number 3, 2001

The minimum rent charged is generally so high that the percentage rate almost never applies in reality. Of 4,000 retailer survey respondents<sup>2</sup> that were on a percentage rent lease, less than 0.25 percent actually paid percentage rent, and those were all on a special deal based purely on percentage-rent with no minimum rent charge.

Knowledge of turnover figures allows the landlord to build up a substantial profile of the tenant's trading performance and thus places him or her in a strong bargaining position at the time of lease renewal.

This is very evident in the rent increase for a tenant renewing a lease in a shopping centre where the landlord has knowledge of the sales turnover, compared to in a strip shop where the landlord does not have this knowledge.

All the major management companies have built up databases of turnover figures that are accessible to a large number of employees. This information is readily shared between management companies, despite the non-disclosure provisions of the various Retail Leases Acts.

Further, information on turnover and rents is exchanged between centres due to the relatively high turnover of management and leasing staff moving between centres and sharing intellectual property on tenants.

Retailers are reluctant to take action against the transfer of their turnover information for fear of reprisal.

**Landlords require sales turnover information so they can push rent levels to the absolute limit of the tenant's ability to pay, forcing retailers to cut business costs in order to be able to pay the rent. As an unfixed cost, retailers are often forced to reduce expenditure on staff and thus less people are employed in the retail sector.**

## **9. EXAMPLES IN A METROPOLITAN REGIONAL SHOPPING CENTRE**

Recent examples from a metropolitan regional shopping centre, where a number of retailers were renewing leases at the end of a five year period, demonstrates the misuse of turnover figures.

### **Example 1 –**

During a five-year lease, a retailer doubled his sales to a level twice the industry average for his category. During the term, the centre landlord added four more retailers to the category, to total twenty-two.

The tenant was in the last year of the term and paying a rent of \$3,675.00 per square metre, representing an occupancy cost to sales ratio of 10.7 percent.

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<sup>2</sup> Australian Retailers Association National Occupancy Cost Survey, 2000

The landlord offered a new lease term at \$6,380.00 per square metre - a 74 percent increase.

This is 96 percent higher on a per square metre basis than the next highest rent charged in that retail category in the centre, but the landlord argued that the tenant could afford it because of his turnover and growth levels.

Further evidence indicated that rents charged to the centre's other retailers in the same category ranged from \$2,128.00 to \$2,696.00 per square metre.

**The premium rent was set based on the knowledge of the sales figures provided by the tenant to the landlord, and has no relation to current market rents.**

## **Example 2**

A tenant was due to end a five-year lease in May 2003. There were sixteen other retailers in the same retail category in the centre.

The tenant was achieving sales 30 percent higher than the JHD March 2003 Retail Averages for that type of store in that type of centre. The store's rent in the last year of its five-year lease was \$1,344.00 per square metre, approximately 10 percent above the JHD average occupancy cost.

The landlord's offer for a new lease was \$1,867.00 per square metre, a 38 percent increase on the current rent and well in excess of other retailers' rents in that category.

The next highest rent for a similar store recently negotiated is \$1,444.00 per square metre, some 30 percent less.

**The landlord used knowledge of the tenant's turnover to set the highest possible rent instead of using market indicators.**

## **10. WOULD THIS HAPPEN FOR RESIDENTIAL RENTS?**

What would the community do if residential tenants were forced to notify landlords of their earnings before rental fees were determined?

There would be a great outcry from various groups and no government would allow the position. Yet the very same thing is happening to retail tenants.

## **11. FAILURE OF UNCONSCIONABLE CONDUCT PROVISION**

The Retail Leases Act 2003 Victoria attempts to facilitate the use of the unconscionable conduct provisions of the TPA as a way to help tenants avoid being forced to provide sales figures as part of percentage-rent clauses.

However, this is not effective because it places the tenant in a position where he or she needs must prove that a landlord has been unconscionable by misusing sales data. This creates an adversarial process between a landlord and tenant. Further, the cost of legal fees for a retailer would be at least \$50,000.

**The proof required to show that a landlord had acted unconscionably, and the financial burden on the tenant to attempt to do so, make using the unconscionable conduct provisions of the TPA almost impossible. A mandatory code of practice for leasing is needed to protect tenants from having to provide turnover figures.**

## **12. LEASES FOR SMALLER RETAILERS COMPARED TO MAJOR STORES**

Major tenants have large space requirements, major capital investment to fit out and stock and long-term commitments to a lease that can range from 15 to 25 years. These factors mean there is a different application of percentage rent in major tenants than for smaller specialty stores.

A major tenant would negotiate a base rent of approximately \$190.00 per square metre and a percentage rent factor that varies from two percent of gross sales to less than one percent.

There is a substantial difference between the percentage rent charged to a major tenant and that charged to a specialty retailer.

The structure of percentage rent for the majors is such that it will never exceed two percent, including the recovery of outgoings. If the specialty retailer were able to maintain that the percentage rent would never exceed eight or nine percent of sales, our view is that they would be willing to agree.

## **13. CONCLUSIONS**

Small retail tenants in shopping centres are subjected to a range of anti-competitive and unfair practices by landlords. One widespread problem is the insistence of landlords in applying leases with a percentage rent clause, which is often misused to ensure the highest possible rent is extracted from a tenant.

A mandatory code of conduct needs to be established between the ARA and the SCCA to ensure fair and reasonable practice in tenancy dealings, including in the area of leases with percentage rent clauses.

The effective implementation of such a code needs to be policed by a national body with appropriate powers, based on a similar model to that used in Victoria where a Small Business Commissioner supports the Retail Leases Act 2003 Victoria.



## APPENDIX A

### Analysis of differences in rent between US and Australia

A study undertaken by Chun, Eppli and Shilling titled 'An Analysis of the Relationship between Retail Sales and Shopping Centre Rents' and published in the *Journal of Real Estate Research* Vol 21 Number 3 of 2001, indicated the following relationships for the specific retail categories:

Category	Sales PSF	Rent PSF	Size of store SF
Specialty Apparel	\$430	\$37.6	2843
Shoes	\$419	\$34.0	2174
Jewellery	\$796	\$77.6	938

The table below converts the above figures to square metres and the US dollars to Australian dollars.

Category	Sales PSM	Rent PSM	Size of store SM
Specialty Apparel	\$6759	\$589.22	263
Shoes	\$6588	\$534.74	202
Jewellery	\$12,519	\$1220.42	87

The figures were collected from a major US Shopping centre owner and are 1995 figures.

The table below compares these figures with those published in the JHD Averages for 1995 for Australian regional shopping centres.

Category	Sales PSM	Rent PSM	Size of store SM
Specialty Apparel	\$6105	\$1208	113
Shoes	\$6108	\$1184	120
Jewellery	\$10765	\$1682	72

It can be seen from these figures that whilst the productivity rates are similar for sales, the rent can vary in Australia compared to North America from 38 percent higher for jewellery to 105 percent higher for specialty apparel.

## APPENDIX B

### Example of how percentage rent works unfavourably in Australia compared to US

	<b>Australia</b>	<b>USA</b>
<b>Minimum rent</b>	\$120,800	\$58,900
<b>Sales per annum</b>	\$610,500	\$675,900
<b>Break in figure</b>	\$1,208,000	\$589,000
<b>Sales applicable to 10% rent</b>	0	\$86,900
<b>% rent payable</b>	0	\$8,690
<b>Total rent</b>	120800	\$67,590
<b>Rent per square metre</b>	<b>\$1,208</b>	<b>\$676</b>

The Australian store would have to double its sales before paying percentage rent.