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EVALUATING THE RISK OF: MULTIPLE LEASES; RENT TO RISK MULTIPLES; AND MARKET VALUE TO GEARED ASSETS IN THE RETAIL PROPERTY SECTOR

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ABSTRACT

Purpose: To present new, simplified and practical methods, to evaluate risk in the evaluation of risk of income streams, which flows from one retail lease to a whole industry. This paper considers the *consequences* of 'over-renting' individual shops.

Approach: Throughout the course of the Author's career he has questioned and queried the practice of an over-zealous property development industry and what follows. As a trained economist, he understands consequences of 'over renting'; the most patently obvious, supply led development. He has monitored industry behavior and sought ways of doing things better.

Findings: By watching industry behavior, and monitoring "average" retail rents, which increased exponentially, risk *must* increase exponentially. 'Over-renting', in basic economic theory, calls for more supply which must exacerbates a problem. By measuring and linking these things back to standard valuation appraisal practice, this ought to help break a destructive cycle for landlord, tenant, finance, investor capital. The following three models, (which follow on from his first paper), enables one to measure and evaluate:

The risk of multiple leases in one precinct, eg one manager/owner, one retail property;

The risk of the overall rent of an income producing property, linked back to yields (multipliers), perhaps benchmarked against other properties; comparing organisations eg. one REITs against another; and

Linking gearing/leverage to the mix, which acts as a tool to evaluate net tangible asset backing and stress testing it against gearing leverage for the industry as a whole.

Originality/value: The Author believes there is a significant shortfall in the way property is valued appraised. In effect, failing to evaluate the reasonable rent for one lease, causes the rent for a bundle of leases to be over-rented and without testing the "relevant multiplier", causes the product the market value to be inflated. Progressively lower multipliers, applied to progressively untested rent causes a "double multiplier". Following the Author's probing paper in 1995, the adoption of market rent into IVSC Standards in 2000, it is indeed surprising that little work seems to have been done in this area of research.

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Keywords: retail, market rent, profits method, comparison method, market value.

GLOSSARY OF TERMS

Australian Bureau of Statistics	ABS
Australian Property Institute, 6 Campion St, Deakin ACT 2600	API
Asian Real Estate Society	ASRES
Australian Taxation Office – small business benchmarks	ATO
International Valuation White Paper entitled, *The Valuation of Real Estate Serving As Collateral for Securitised, Instruments*, issued in July 2006 which reads in part: *"The Valuer should investigate …. about prospective contractual rent,…. that the data is indeed accurate. Estimates … which are unrealisable, are engineered rents; valuations based on engineered rents will not result in Market Value".*	Engineering/engineered value
Financial Accounting Standards Board, 401 Merritt 7 P.O. Box 5116. Norwalk, Connecticut 06856-5116, USA	FASB
When a given asset may have debt (acquired at a lower cost or price than one pays for equivalent capital), which underpins shareholder (aka the beneficial owners) equity to bolster returns. This can and does occur until the cost of debt increases and returns possibly go in the opposite direction. If a property asset is overpriced or overvalued, and underpinned by debt, a flight by shareholders can and will exaggerate a compression in share prices, aka GFC	Gearing/leverage
Global Financial Crisis (2007 – 2009)	GFC
Headline price people are paying for an asset, eg. average price of apartments or houses in a given area, average rent per square foot/square metre, where no "in-depth" analysis has been done or understood. Set of given factors could be "engineering" or masking the real value of asset, or understanding of real value. Headline analysis implies that persons speaking with supposed authority on the "price" of a given asset may have limited knowledge regarding real asset value.	Headline price/headline analysis
International Accounting Standards	IAS

International Accounting Standards Board	IASB
Intellectual Property	IP
International Valuation Standards (Council), 1 King Street, London, EC2V 8AU, United Kingdom	IVS(C)
Key Performance Indicator	KPI
IVS 40.1. *'Market rent is the estimated amount for which an interest in real property should be leased on the valuation date between a willing lessor and a willing lessee on appropriate lease terms in an arm's length transaction, after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion.'*	Market rent (Gilbert, D. 1995, 2003)
IVS 30.1 *'Market Value is the estimated amount for which an asset or liability should exchange on the valuation date between a willing buyer and a willing seller in an arm's length transaction, after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion.'*	Market value
Left Hand Side	LHS
A measure for something; a means of deriving a quantitative measurement	Metric, performance metric (noun)
Net Tangible Asset value	NTA
Gross rent divided by a business's turnover and expressed as a percentage	Occupancy costs
Amount an uninformed person is will pay for an asset. Underlying value has not been properly evaluated.	Price
Pacific Rim Real Estate Society	PRRES
Real Estate Investment Trust	REIT; (A-REIT), etc.
Right Hand Side	RHS
Royal Institution of Chartered Surveyors, 12 Great George Street (Parliament Square), London SW1P 3AD, United Kingdom.	RICS
Finance industry, academics, valuers / appraisers, real estate practitioners, investment advisors, lessors, lessees, franchise industry	Stakeholders
Australian analytics company who collects processes and presents key	URBIS/Urbis JHD

data about all classes of Australian retail shopping centres	
The opposite of 'Price'; a person or persons are fully informed about the value or market value of an asset	Value/market value
World Association of Valuation Organisations, WAVO Secretariat, 110 Middle Road, Singapore 188968	WAVO

INTRODUCTION

Australia's retail sector employs 10.1% of the total work force according to Wikipedia[2]. It makes up 4.7% of the nation's total Gross Domestic Product set out in a report by the Australian Trade and Investment Commission.

Notwithstanding that it is alleged that we have an economy worth AUD$1.7 trillion, that household wealth stands at AUD$8.9 trillion, hence the retail sector is worth AUD$79.9 billion.

In 2012 core commercial property in Australia was calculated out building by building and worth circa AUD$279 billion, of which core retail was worth 40.0% of that, which is equivalent to AUD$112.0 billion (Higgins, DM. 2013). According to another source Pramerica, Dr. Higgins found that the total universe of Australian institutional grade commercial property is worth AUD$681 billion.

Given that the retail portion makes up 40.0% of core commercial property, then adopting a similar ratio to calculate the universe of institutional grade commercial property, the total retail component would be worth say AUS$272.4 billion.

So, what is the total population of all commercial property worth in Australia, and what is the retail portion worth?

A top line evaluation, with all the embedded flaws in the valuation process, which this research paper uncovers, might suggest perhaps AUS$300.0 - $350.0 billion.

Moving from the academic sphere, let us put some Industry Based Knowledge into the mix. Some of this is inferred, some hard-nosed fact and we can extrapolate what this means for stakeholders in the mix:

- Regional and rural towns and cities, particularly in mining centres or feeder towns to mining centres, have had over-zealous Planning Approval granted for shopping centres and shopping centre extensions. This has led to over-supply of retail property stock. Both property as well as business capital in typical town centres has been severely undermined. Cities such as Townsville, Mackay, Rockhampton, Hervey Bay and Cairns in the State of Queensland, Australia in the Author's

[2] https://en.wikipedia.org/wiki/Economy_of_Australia

opinion were found to be problematic;

- Major Australian A-REITs earning development fees through related companies (Boydell, S. 1998 and 2001) which is and has been a country-wide problem, overlaying existing property and business capital;

- Government owned Superannuation Funds have been granted leniency to do the same in Toowoomba a regional city in Queensland;

- Costco, Amazon, IKEA, and now several overseas supermarket chains, and many overseas clothing stores are being granted approvals to again overlay established distribution and supply channels; not that valid competition is not warranted in Australia, but it is the over-zealous planning approval and property construction aka supply that is seen to be the drivers;

- Apartment complexes all with more shops, many which remain empty, most are on sectional or "strata" title, get loaded with a "business" with the lights on, which gets sold to an unsuspecting "investor". The business fails, perhaps the investor becomes a "statistic", perhaps several businesses and other landlords themselves become statistics, with this "overlay" of more supply on what was previously a relatively stable market;

- More property owned by Government and over-zealously managed at South Bank, Brisbane, Queensland. A better description see photograph below;

- An existing centre in Brisbane, Queensland, owned by a Federal Government pension fund, known as Indooroopilly Shopping Centre, was substantially renovated and "extended" within the building envelope. Poor parking, and high parking charges and ability to exit the centre caused custom to go elsewhere. To justify the substantial acquisition and redevelopment costs, stores in effect were subdivided with similar annual rents (but far higher rents per square metre to "bolster" supposed "value"), but with less overall custom and more direct competitors. The full effect is now being felt and vacancies are on the rise;

- Park Road, Milton, Queensland has suffered the effects of: floods and flooding, the redevelopment of centres within the precinct, endemic thinking that there is room for one more eating establishment, a failure to manage tenancy mixes, rorts[3] by leasing agents about realistic rent levels, engineering rents to maximize leasing and management fees and over-promising to their principals to name a few. Both prospective tenants and property investors have been leasing and buying at "face value" and or their independent advice has been to analyse market value/capital value on headline rent. The analysis of rents on a per square metre basis (per

[3] A fraudulent or dishonest practice.

square foot) has not helped. One "investor", bought a property with quite a well-known brand in situ. Their advisor, only conducted a "top-line" analysis of the rents. They paid circa $4.0 + million for a property, which realistically can only justify say half that. A short conversation with the tenant would have confirmed this fact. A CRE audience may have had capital caught up in something similar;

- Agency based valuers/appraisers (sic), acting more as 'agents' for their principals rather than do an independent job for their clients. They are simply compromised by their overarching responsibility to act in a principal's interests; even breaching Professional(s) Codes of Conduct.

The Author has worked for major Australian retail corporations as a consultant expert. One company, a large conglomerate, is impaired by an intransigent culture from major landlords, who limit them from being able to compete. International category killers like Costco, Amazon, IKEA, and others like Lidl, Aldi, H & M, etc. "walk" into the market versus having to weigh up whether they could justify setting up in Australia and competing. Why? Because landlord "culture" is not allowing them to be competitive, high fixed costs such as rent forces high retail prices.

What this paper will seek to extrapolate, is, an over-zealous development, leasing and management culture, where rorting is rife across a wide sector, what this means for stakeholders. Compliance under IAS 16, software to evaluate what one ought to pay and receive set out in *Evaluating the reasonable rent for One Retail Lease* (Gilbert, 2017), and methods, systems, software to evaluate, quantify and quarantine:

1. The reasonable rent of rental income streams otherwise copyrighted and trade marked as GEM Two™ ('Gilbert Evaluation Method');
2. An evaluation of the relationship between rent being paid linked to a respective multiplier, hence the bona fides of market value copyrighted and known as GEM Three™; and
3. An evaluation and linking of the bona fides of market rent linked to gearing and or risk known as GEM Four™;

are tools in the mix to reduce risk, increase certainty on income streams and hence market value. They are also tools to match capital to investments and reduce waste aka over-supply.

Each day the Author takes calls. Before 10.00 AM this morning, there was a restaurateur who had been bundled into a lease renewal, justified on a dollar per square metre basis. It included a new renovation, within 18.0 months he has significant arrears. It has become a legal matter.

A butcher with a lease renewal, a major A-REIT has made an offer, who has been presented with a GEM One™ evaluation of why the rent would be unfair and not comply with IAS 16. It has since been resolved. The business was paying circa $91,000, the A-REIT sought

$95,000 with minimum 5.0% increases, the centre performance metrics were static. The GEM One™ evaluation suggested circa $70,000. The new lease will commence at circa $75,000 with lower increments.

Another butcher in a major A-REIT centre has recently undertaken a significant shop refit who already is under leasing stress; a gift wear shop who is being bullied into accepting a significantly distorted rent at almost double the industry standard which is subject to market review.

Below, are photographs and brief case studies which will be of interest to readers, outlining the technical issues in the mix which is leading to a significant disruption in the industry and is causing significant losses for *all stakeholders.*

In 2014, there were swathes of empty shops and properties in Central Business District ('CBD') Townsville, Queensland, Australia. Typically, ownership of smaller CBD property lies in the hands of families and family companies.

More CBD Townsville, in 2014. An open market review process enabled a supermarket rent to be reviewed to current market. The rent declined from $450,000 to $250,000 or thereabouts. It was the purpose of the visit and the business is trading soundly.

Above the consequence of an over-zealous planning approval process, plus the poor mixing of retail shops in South Bank, Brisbane, Queensland. Two large eating establishments opened up within theatre complexes, on top of too many food offers.

This overlay and saturation of retail food has caused the underlying or established business to close. A contributing factor was landlord intransigence, failure to balance tenancy mixes and or continuing to pursue high fixed rental rates per square metre and ignore business performance.

Above and below, a new redevelopment in Indooroopilly Shopping Centre, in Brisbane, early closure of the fish shop in under 6.0 months. Below a small-goods business. The detail is extremely impressive, suggesting they and other shops were promised significant custom. The Author has many more photographs (2016), which presents the extent of the problem.

Just off Park Road, Milton, in Brisbane, Queensland below, is another restaurant food outlet. It closed shortly after the lease commenced. To get the rental rate up, to get the purported "value" of the freehold up, it is alleged that the company who developed the property paid for all the set-up costs for the business. When it has come to reality however, there is simply too much food in the catchment and secondly, even with business establishment and set-up costs paid by the developer/landlord, there was insufficient cash-flow to trade successfully.

In the same area, below is the photograph of a fully set up restaurant in the heart of Park Road. The landlord, who owns the adjoining business, took over the premises when his tenant vacated and left the fixtures and fittings in situ. It is alleged that the landlord, in effect operating the business in the premises he owns is unable to cover wages.

Here is a shoe shop in the same area. It is alleged that turnover levels are now just 40.0% of levels they were some ten years ago.

The precinct has lost its regular traffic and trade, because it lost its diversity.

With this background in mind, we now discuss evaluating the risk of: multiple leases; rent to risk multipliers; and market value to geared assets in the retail property sector.

EVALUATING THE RISK OF MULTIPLE LEASES IN ONE PRECINCT, FOR EXAMPLE A LARGE SHOPPING CENTRE AKA GEM TWO (GILBERT EVALUATION METHODS) ™

The evaluation of risk for multiple leases is presented in Figure 1 below. The methodology acts as a tool to evaluate, assess, quantify and quarantine disproportionate rents.

The evolution of this methodology occurred in 2006 or thereabouts when the data came to hand, however it was only considered as a risk evaluation, measuring and mitigation strategy tool by the Author in around 2010.

All that is necessary to describe for the purposes of this paper is that the vertical axis presented by the red bar graph/charts represents the average occupancy cost of each category being paid in the centre (gross rent as a percentage of turnover), and represented on the horizontal axis, starting with the permitted use category “fruit & veg,” aka fruit and vegetables, and ending with the permitted use “dry cleaner”. The blue bar graph/chart is the corresponding and suggested independent benchmark that each category ought to pay, which comes from reputable accountancy based organisations.

The Australian Taxation Office has small business benchmarks, and similar benchmarks Lessors used in the old BOMA Tables (‘Building Owners and Managers Association’, which is now the Property Council of Australia) is referred to in ‘*Determining Suburban Shopping Centre Rentals’* (Willington, P. 1987). The Author found remarkable correlation from various sources in his 2003 paper - sources are in the section.

Effectively, referring to Figure 1 the independent benchmark source's trend line for fruit and veg commences and ought to pay around 3.0% of turnover per annum and ends at circa 10.0% of turnover per annum for the dry cleaner permitted use, whereas each corresponding category for the centre in question was actually paying circa 10.0% to 22.0% of turnover, referring to the upper trend line as the reference point (and higher and lower than the 'average' as the case might be for each category made up of multiple leases).

The middle line is a line introduced by the Author on the premise that it is slightly higher than the suggested benchmark and could be justified because large shopping centres introduce higher traffic flows and potential sales (assuming tenancy mixes are properly managed). Businesses will achieve larger economies of scale and their occupancy costs can be higher. Some of the reasoning for this is covered in *'Market Rent Revisited'* (Gilbert, D. 2003).

Now individual readers of this paper could have business capital in the mix, and this could help to explain how it occurs. In the process, in having this knowledge, one might then be able to understand that in effect the status quo is unhelpful to either their business or the landlord's investment and actively do something about it.

Further intense evaluation needs to be done on: each occupancy cost benchmark of each of several hundred business models, to evaluate investment in business models (capital, stock, fitout); key operating expenses such as wages; occupancy costs and economies of scale at various levels of trade, linked to tenancy mix optimisation and maintenance of minimum maintainable sales and business models individually, per type of business within the tenancy mix and all specialty shops as a whole within one retail complex. These relationships might also be explored across countries borders, in other words do fruit shops in the United Kingdom, pay the same gross rent to turnover as they do in the USA, Canada, Germany, etc.? What do fresh fish shops pay, takeaway shops, electrical shops?

This area of research is skewed towards property economics, accounting and cost accounting (Gilbert, D. 2016; Macrae, M. 1996; Millington, A. 1996).

For the purpose of *evaluating the risk on rental income streams*: rental income *less outgoings (landlords operating expenses)* up to the middle trend-line represents moderate risk and warrants higher multipliers to produce market value (bearing in mind this is based on the Author's expertise as a commerce graduate, and having done many Profits Method rent evaluations (Millington, A. and Macrae, M. 1996)); the next tranche up to the upper line might be considered high risk income; and anything above the upper line, extreme risk. This of course implies even lower multipliers to produce more consistent market value outcomes.

And some of these reasons of over-renting is the driver of supply led development, which overlays more supply on any given market, which is destructive for stakeholder capital.

Refer Attachment A. Figure 1 Evaluating the risk of multiple leases in one precinct eg.

under one manager

In the event that these trends have gone on for an extended period, expect higher risk income streams and, if there are changes in the economy, the overall position could be exaggerated. That is because tenant reserves and liquidity would have been diluted paying disproportionate occupancy costs.

So, unlike a residential, office or industrial precinct, where comparables are usually concentrated and *relatively generic*, the retail precinct is sliced and diced by up to 1/200th via:

1. Permitted uses; and
2. Further, sometimes, via significant differences in each retail site, i.e. the comparable; and
3. The structure of the leases.

In the absence of anything better, it is strongly submitted that this is a reasonably credible way to evaluate and quantify risk on specialty shop retail income streams for one precinct or one shopping centre.

In Australia the data is readily available; however, efforts are being made to have third parties collect and process the data as it has been questionably used. In the event that the information is not available in other parts of the world, one can achieve reasonable outcomes to evaluate store performance levels by being *an independent valuer / appraiser,* and by asking certain key businesses questions to a sample of key businesses such as: *"Does this store trade at say between $1.0 to $1.3 million per annum? Is it closer to $1.0 or $1.3?"*.

One can then build up a reasonable picture of a centre's performance levels, to evaluate risk on rental income streams.

EVALUATING THE RISK OF RENT TO MULTIPLIERS OR GEM THREE (GILBERT EVALUATION METHODS) ™

This is a recent invention by the Author in the form of usable software, but it has evolved since 1995 or thereabouts, seeking to link and present high rents being charged to higher multipliers. When both higher or disproportionate rent is multiplied by a high or disproportionate multiplier, aka a lower yield, the combined 'multipliers' must be even more disproportionate or exaggerated, hence *"blinding flash of light"* valuation appraisals[4].

What about adopting and using Discount Cash Flow ('DCF') methods? One still needs to understand the hard numbers presented by GEM Two™ above. What discount rate should

[4] Sir Frank Kitto former Justice of the High Court of Australia in (1992) 66 ALJ 787 at 797

one adopt? It still depends on the headline rents being paid, relative to business performance metrics. Are underlying performance levels increasing or contracting, do rent escalations match the centre performance metrics? Are tenancy mixes being managed properly?

Are the landlord's management operation maintenance fees and charges competitive, whether passed on to the tenant on a net lease, or inclusive in the gross rent, and how does it impact on the overall gross rent, hence what net rent is left in the mix? And obviously is the property being maintained and or suffer obsolescence?

The upper trend line, supported by bar graphs/charts, in figure 2. represents "average" escalating rents and the lower trend line, falling yields (higher multipliers). As long as the graphs/charts are diverging, the multipliers are both increasing and when they are converging/flat the multipliers are static / falling. In both instances, both become exponential, hence more sensitive as one moves along each curve. For example, off a 10.0% yield, the multiplier is 10.0 X; an 8.0% yield is 12.5 X; a 5.0% yield is 20.0 X and a 2.0% yield is a 50.0 X multiplier.

Obviously as a yield gets lower, the sensitivity levels increase and so a small change becomes exaggerated. And that is why our low Central Bank cash rates are problematic off a low base. When the data metrics re-adjust, when Monetary Policy levels are readjusted back to "neutral" levels the corrections might be quite large. But that is a whole different study; but the mechanisms are similar as described above.

The same applies to a rental base, whose 5.0% increases, for example, become exponential over time. When the actual risks increase, linked to actual store productivities, and are multiplied by a higher multiplier, so the "engineered" opinion of market value in the absence of "testing" will increase exponentially by a double multiplier.

It is submitted that the more advanced or dated a property or precinct is in its life-cycle, particularly if it has been intensely managed, the more store performance metrics can flatten out or go into decline.

Rents could be advanced in terms of having been ratcheted up over consecutive terms of the operation of businesses (Crosby, N. 2006). Precinct or shopping centre renovation and refurbishment can extend and reinvigorate old or tired assets and or address obsolescence life-cycle factors.

And the longer this continues, so the status of the metrics decline. And that is basic common sense.

Refer to Attachment A: Figure 2 Evaluating the risk of rent to multipliers

If, for example, average occupancy costs are assessed as high and escalating, then the risk profile of the centre has to be higher and vice versa. Active consideration and management of risk must result in better outcomes versus boom bust methodologies and application of legal outcomes.

The evolution of this model links back to the Author's thinking of the collapse of the Japanese Real Estate sector, when asset prices ballooned in the late 1980s early 1990s, with commercial property in 2010 worth say 10.0% of 1990 – 91 levels in six largest city areas and residential property worth around 25.0% over the same period.

Japan has never really recovered from this misallocation of capital over the period which led to asset and share market inflation when Bank of Japan interest rates were as low as 2.5% per annum in the period leading up to the crash 1986 - 1989[5].

Since the GFC Central Banks have continued to prop up the financial system, eg. Troubled Asset Relief Program ('TARP') (Geithner, T. 2014) and central bank interest rates were lowered to "emergency" levels. Asset prices and investment markets have generally increased, with speculation and manipulation transcending into property asset prices and residential real estate (various classes), etc.

Only now is there an apparent shift in Central Bank policies, and in the meantime Government Authorities are having to change policy/ies in regard to bank lending, who buys real estate, etc. Manipulation by speculators has become brazen.

The A-REIT sector has not been immune to this manipulation, and a recent article in Australia alerted the Author to consider high rents relative to "engineering" lower yields and to justify higher multiples, hence higher "valuations". It did not add up and it appeared to be a repeat of pre-GFC manipulation. Perhaps it could be related to executive remuneration packages.

But is this in most stakeholders' interests? Does this alter the balance of a long-term asset class? How does it add up? Were these the ingredients that led up to the spectacular asset price crash in Japan? Is this pre-1975 and 1991 behaviour in the UK (Crosby, N. 2006)?

Should bolstering short-term asset value of a long-term assets be encouraged, aka reacting to share market corrections, particularly of geared assets (see GEM Four™ below)?

The linking and presentation of cumulative rent increases, particularly linked to aggressive renewal policies; maintaining high rental increments; failure to optimise tenancy mix, particularly when average occupancy costs are very high, which when they escalate, impact severely on financial viability and return on stakeholder assets (Hyam, A. 2004; Macrae, M. 1996; Millington, A. 1996). Business owners ought to understand, because the manipulation of these metrics, to supposedly add "value" to an income producing property, often is no

[5] https://en.wikipedia.org/wiki/Japanese_asset_price_bubble

more than transferring asset value via the lease.

When rent, for example, is 10.0% of turnover, a five percent increase equates to 10.5% of sales, assuming zero productivity increase. The same 5.0% increment on a 20.0% or 30.0% occupancy cost equates to 21.0% and 31.5% with no productivity increase.

When turnover falls and rent escalates, and there are hungry franchisors hanging off businesses, the ability to cover fixed costs and generate a return to justify one's business establishment costs diminish exponentially. Analysis of this exercise for over 200 business models is a cost accounting and business valuation exercise. And risk accumulates exponentially. Why or how, then, can risk multipliers be increased? Is this "engineered value"(IVSC, 2006)?

As stated, when disproportionately high net rent multipliers "multiply" higher multiples, assuming or purporting to lower risk levels, then one has a double multiplier to produce an even more "engineered" market value, hence the evolution of the above model, which considers the relationship between higher rents and higher multiples for conscious evaluation and application.

Substituting average occupancy costs for a rent number in Figure 2 introduces a "control" linked to actual store performance metrics. It is able to be benchmarked against industry performance metrics.

Either single properties, segments of the industry or the whole industry itself can be stress tested and linked back to common benchmarks over a period of time.

It dawned on the Author that the model can be used for other asset classes, eg. residential real estate, where the "price" is linked to low interest rates over time (as a whole or by segmenting a market, by city, by town, distance from city centre, etc.), for bond markets, commodity markets, etc. Low interest rates and Monetary Policy.

This method forces one to interrogate, evaluate and stress test average rental metrics of one centre to other centres or precincts; or a particular A-REIT group to a set of developed standards or benchmarks. One ought to consider the stage, the centre or precinct in its product life cycle, and whether "reasonable occupancy costs" and increments are matched to store performance metrics and so on.

EVALUATING MARKET VALUE TO GEARED (LEVERAGED) ASSETS (CROSBY, N. 2006) GEM FOUR (GILBERT EVALUATION METHODS) ™

In 2006/2007 the Author was pondering about the relationship between gearing/leverage and lease risk. At that point he already had a firm grasp of average specialty shop occupancy costs and had turned his attention to current market rent and risk (Gilbert, D. 1993 and 1995) in seeking ways to contain asset "price" inflation in pursuit of more responsible industry behaviour.

It was apparent in 1989/1990 that Real Estate firms and Management Companies who derived commission fees, but who also practiced as valuers / appraisers, may have conflicts of interest.

The Author already had comprehensive knowledge regarding individual occupancy costs for various business models, and average occupancy costs (Urbis/JHD) and had received several documents, dating back to 1997, about the average specialty shop occupancy costs for three major shopping centres owned to a large A-REIT.

By quickly scanning the data, it became apparent that an individual shopping centre could have widely disparaging occupancy costs compared to the retail shopping centre averages which URBIS/Urbis JHD were publishing. This was a patently obvious consideration, given that an “average” can be made up of a wide range of numbers.

It became industry practice in Australia to justify rent increases, using URBIS “averages”, by linking anything lower than the “average” and leveraging the rent up. In simple terms, one’s outcomes became a self-fulfilling prophecy.

From early 2000 it was being reported in the press that major property groups were using debt (cheap money) to bolster shareholder returns and to acquire more real estate. The first authoritative paper available enabled the Author to dwell on this problem, and then to build a model to illustrate what could occur, with the “average” gearing levels of the A-REIT sector at 36.0% and the then Centro Property Group justifying USA acquisitions on management fees, versus underlying asset value with debt of 60.0% plus (Newell, G. 2006).

The graph/bar chart presented as Figure 3 below with assumptions considered a correction if shareholders perceived that asset value did not support the share price, and they sold their shares en masse. The basic assumption was that specialty shop rents did not support market valuations and were 33.0% above the long-term sustainable occupancy cost: 18.0% versus 12.0% of turnover (today we know occupancy costs are much higher).

See Attachment A: Figure 3 The graph/bar chart links gearing/leverage to the mix, to assess and evaluate NTA backing against gearing/leverage levels

In effect, stable “market value” was being generated by 30.0% of major retailer income streams, say ‘blue chip’, with 70.0% coming from specialty shops in 30.0% of the floor area. This is a similar ratio to the one touted in press articles the Author recently read in the USA.

Assuming 70.0% of the long-term market value was only contributing to 46.2% of the underlying value, plus the blue-chip portion, then the NTA could perhaps only equate to 76.2% of the asset’s true underlying value for several major centres. Now, given the real figures, which had come into the possession of the Author, and that the consumer was then under pressure in 2007, these assumptions were reasonably conservatively sound.

Given that the average gearing, according to the Newell paper, was 35.0% of average A-REIT NTA value, then 24.0% was propping up asset value: 100.0% minus 76.2% = 24.0% shareholder equity, *given these assumptions* were 100.0% - 46.0% (geared portion being a higher proportion of lower asset value) – 24.0% (propping up value via inflated NTA) = 30.0%. In other words, the shareholders portion was not 65.0% of the mix, it was only 30.0%.

Adopting the same assumptions for an asset which had 60.0% gearing, being acquired en mass on the justification of "buying management rights", suggested far less scrutiny when, shareholder equity was in fact backed by assets of zero or close to zero value.

Hence the assumptions of higher multiples off high unsustainable (and untested) market value, with banks and financial institutions lending on same, could have disastrous consequences and they did. Today of course, many companies are issuing their own debt to finance similar design and construction activities, as documented by Prof Boydell (1998, 2001). Today the consequences for shareholders could be similar or worse.

Notwithstanding that, the methods and assumptions below predicted:

1. The $65.0 billion-dollar correction of the A-REITs weighted to retail to within 3.0% off a pre-GFC market cap of $100.0 billion, presented by the second graph/bar chart in the middle; and
2. The virtual demise of the Centro Property Group, whose market capitalisation fell from $12.0 billion in two trusts to around $100,000.

CONCLUSIONS

The Author believes all stakeholders would be the beneficiaries of leases which have stood the scrutiny of informed market outcomes. And it follows that:

- Directors of Companies have fiduciary responsibilities to protect their companies' assets;

- From January 2019, Lessee company leases must be properly evaluated for compliance under IAS 16. Many leases are already afoot which will be in existence as at that date;

- Many leases may already create negative value on company Balance Sheets from that date;

- Lessors also have responsibilities, which could incorporate Property Trusts;

- The finance banking industry would benefit significantly if they could make lending decisions on more accurate valuation appraisal opinions. The cost of writing off bad debt is a significant impost and dilutes shareholder value[6] (Becker, C. 2012);

- By isolating and quarantining various elements of risk in the valuation process, and following process in a disciplined way, one can reduce variables with more accuracy, which should produce more consistent valuation appraisal opinions;

- IVSC, RICS, WAVO and API are seeking to lift valuation standards. And the accounting finance industries are playing their part;

- All the stakeholders mentioned in the Glossary of Terms, *must benefit substantially* if there is to be better matching of stakeholder capital in the retail property sector; both for investment *and* divestiture decisions;

- To date, research and research papers are limited to causation and consequences of ill-informed rent evaluation and negotiation outcomes, from single leases to a whole bundle of leases in a single investment property, to the industry behaviour as a whole. It appears that there has been no or limited work with practical steps to fix the problems or understand anything beyond headline 'price' vs real value. Legal avenues have proven tepid;

- There are at least three PhD possibilities in this paper for the property sector alone, namely: rental income streams and risk; linking rent and lease risk to yields and multipliers for segments of the industry to the industry as a whole to produce market value; and one linking risk on income streams to gearing leverage;

- Figure 2, presented as GEM Three™ could include other disciplines eg. linking low interest rates over time to high house prices; the consequences of low central bank interest rates over a period of time to economic activity aka monetary policy (economics); low interest rates to share prices/share market indices (investment); low interest rates to finance borrowing/lending, bank balance sheets, quality of "loan books", quality of depositors funds/bank balances (finance); interest rates and bond prices (debt financing); commodity prices, etc.;

- It is submitted that a whole new area of expertise could be developed in this arena, to significantly improve the way capital is allocated in the retail property sector;

- One only has to consider the significant shift to online shopping, as business capital seeks new ways to generate its return at a cost to existing business models when customer traffic declines, with obvious chicken and egg consequences for those who

[6] *"Bank of Queensland (BOQ) is going to post a first half loss on a near tripling of its bad loan impairments."*

have capital in the mix;

- In closing, just as Timothy Geithner, Treasury secretary to Ben Bernanke and Henry Paulson, points out in his book, *Stress Test*, the crippled financial system needed to be fixed, which flowed back into the wider economy during the GFC. In a similar vein, the A-REIT sector crashed, which arose out of financial engineering of what is essentially a reasonably simple investment model;

- The 2007 – 2009 crash arose out of a loss of confidence in the viability of this investment class due to engineering. Ironically, neither the wider US economy nor the underlying problems in the A-REITs have been addressed. They are probably worse;

- Applying the methods, systems, models and software would bring about a modest but necessary correction and ensure proper allocation of stakeholder returns over time unless, of course, there is a complete loss of confidence in the economy. Given the poor management of monetary policy by central banks who seem to lack an understanding of High Street, this is a distinct possibility;

- Lastly, it is not the quantum of this paper, but the cumulation of research for some fourteen papers (some presented at several conferences) comprising some 80,000 to 100,000 words locally and overseas, which is important;

- This body of research has included / come from someone with quite a wide educational background, from on-the-job learning, hundreds of case studies and articles, and submissions to various Governments to improve legislation, which the Author believes will open up a new area of real estate learning that is vital for the more efficient allocation of capital to this sector, which must have environmental benefits. This could create at least 10,000 jobs in the lease evaluation arena;

- Intellectual Property, accompanied by scalable software which substantially empowers an end user such as: an accountant; a consultant; a banking finance executive; a real estate firm; a buyer or seller of real estate; a portfolio manager; academics; valuers/appraisers with methods systems disciplines, and clearly presented reports which reduce peaks and troughs must benefit stakeholders. How has it been possible for the USA to build up stock of retail property of 24.0 square foot per capita? How will divestiture decisions be made, on what criteria?

Perhaps stakeholders put £40.0 million into a research and education grant managed by RICS for this IP? It would be a drop in the ocean compared to real losses that can be made on one property alone.

ATTACHMENT A: FIGURES 1 TO 3

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