Market Rent: What Is It?

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The author of this paper believes valuers and land economists have vital roles to play in enhancing relationships between shopping centre owners and tenants. This, he says, will not only benefit owners and tenants, but will also lift the profession's profile in the eyes of the community.

In October 1987, the stock market crashed. The reason was that the market had overheated. In falling, investors were rewarded with real returns on their investments. In the early 1990s, the same happened to real estate. Rather than seeing rents fall back to realistic levels, rent free periods have been offered to commercial tenants and some owners/managers have managed to keep retail tenants, and even increase rents, by threatening non-renewal.

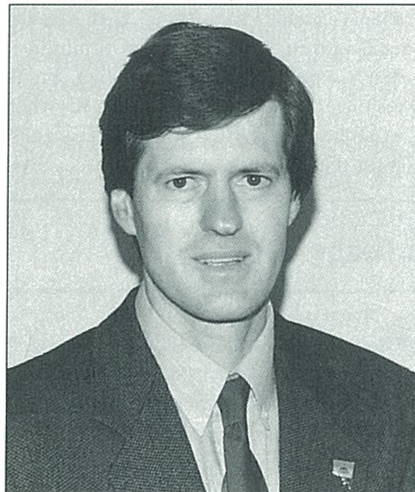
In the short term, a proprietor may be able to operate by cutting corners. However, in the process, the long-term viability of the business can be irreparably damaged. Many proprietors have exceeded their limits and unless rents are re-negotiated, their businesses will fail. Once again this will put the property profession under the scrutiny of the media and other professionals.

Sections 51AB, 52 and 54 of the *Trade Practices Act*, together with amendments to the Corporations Law from 1990 to 1993, make it possible to correct many practices which no longer fit the way business is done in the 1990s.

Once financial ratios for a particular business profile have been assessed to gauge whether a tenant is maximising his business opportunity and the proprietor is performing as well as possible (according to best business practice), other factors need to be examined. These are standard valuation measuring tools such as size, frontage, permitted use, location, level of trade, economic activity, potential in the catchment area, etc.

What then is market rent? Surely the International Valuation Standards Committee definition of market value must apply.

> Market value is the estimated amount which an asset should exchange [including leased space] on the date of valuation between a willing buyer [tenant] and willing seller [landlord] in an arm's length transaction, after proper marketing, wherein the parties had each acted knowledgeably, prudently and without compulsion.



If a tenant is not making a profit one needs to ascertain the rent ratio as a percentage of sales. The only exception is when tenants do not maximise their trading opportunity.

Market research indicates a multi-tier rental system exists between anchor tenants, national and larger state-based operators, and sole traders who pay the highest level. This was confirmed by Herron Todd White (NSW) which stated: "owners use the small traders to recoup the losses they make on the special deals they have to offer to attract anchor tenants".[1] Using a normal risk and return scenario, one would expect a small difference, but the variation between large and small retailers is out of proportion. By manipulating the market, the industry has effectively forced the "floor price" above the natural point where supply equals demand. The message to developers at higher levels of rent is to build more property in whatever category. This is clearly illustrated in Fig 1 and is similar to the conditions that led to the large stockpile of wool in the early 1990s.

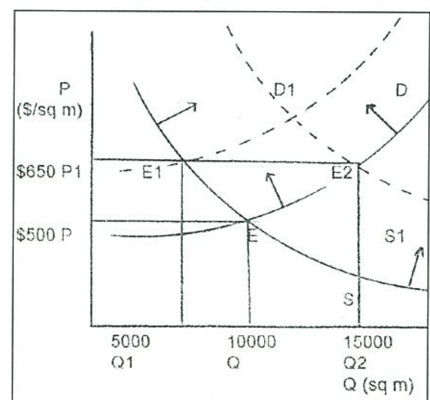
At E, supply equals demand. Rent is $500 a square metre for the 10,000 square metres of trading space available. The industry has manipulated the floor price up to P1, say $650 a square metre. At P1, tenants can afford only 5,000 square metres shown as Q1 (demand should fall to D1, but tenants are locked in by leases and financial commitments). Developers doing feasibility studies at $650 a square metre believe more space is required and want to supply 15,000 square metres at Q2.

E1-E2 shows the distortion in the market between supply and demand for trading space. This happens when there is an artificial floor price above the equilibrium point E where supply equals demand. If both owners and tenants could negotiate freely, this distortion would not occur. If the floor price were to fall back to its natural level, then supply would be satisfied by normal growth in the economy.

RENT COSTS – RISK AND RETURN

Research shows that in many cases occupancy costs (rent and outgoings) are already high in real terms. They are too high for the type and level of business activity some traders experience. Some owners and managers are pursuing a growth path off too high a base, ignoring the risks. One suggestion is to use three discount rates that reflect the risk in relation to the security of tenure.[2] High occupancy costs are detrimental to the retailer's business, the investment property and, if mortgaged, the lender who may have to call in loans.

Figure 1



The valuer, by taking charge of the situation as a disinterested professional, should indicate to those relying on a report that there is a potential problem. Reflecting the risk in the value addresses any optimism in an owner's mind and gives a lender certainty.

On the other hand, a land economist giving professional advice by suggesting rent reductions for the right reasons, initially may raise eyebrows. However, in the long term, the owner has happy and profitable tenants and the investment property is more secure and competitive. It will also promote harmonious relations between owners/managers and occupants.

By leading the way rather than following, the integrity of our profession is ensured.

OCCUPANCY COSTS

My discussions with experienced retailers about occupancy costs indicate that retailers believe many property practitioners no longer understand how business works. This begs the question, what is the yardstick for measuring rent?

Rent per square metre is used by both valuers and land economists to measure the performance of buildings and rentals. As a constant, it is the obvious way of comparing apples with apples. Unfortunately, it now appears to be the driving force in achieving rental growth, without taking risk into account.

Rent in real terms as an actual cost to a business has become irrelevant. Turnover and customer counts which measure the performance of a centre are used to measure the performance of a trader! These points have little bearing on the most important thing for any business, irrespective of the size or type of operation, namely the bottom line profit.

TENANTS' NEEDS

Tenants often are not presented with the true picture and a larger slice of sales is going to the majors. Anchor tenants are experiencing a major growth in sales, to the detriment of the speciality shops which pay more rent. Turnovers are falling and rent ratios are increasing. The risk of failure by many small retailers is high. Many leases may have to be re-negotiated, despite the fact a tenant may be in the middle of an agreement. Ratios are not monitored and retailers are finding it hard.

Many property practitioners are making themselves unpopular with customers (tenants). Instead of parties sitting down with open minds to discuss what the business can afford to pay, intimidation tactics are used to achieve unrealistic budgets.

An essential element in marketing is an understanding of the client's needs. Real estate terminology is only understood by those in the industry, hence there is a communication gap between the supplier (owners/managers) and the consumer (tenants).

Essentially, traders are interested only in what it costs to open their doors to do business. Tenants really are not concerned whether the landlord calls it rent, outgoings or whatever. They want to trade from a well maintained, well promoted building at, say, $70K per year. Gross rent with a clear review mechanism would satisfy many tenants, as long as it is fair, and if they work hard, there is something in it for both parties. Rent and on-costs have become an issue because occupancy costs have continued to increase and are disproportionate to the tenants' share of takings.

During the recession, alternative means have been used to achieve income growth and this is what tenants oppose; they have little control. Some owners/managers have achieved revenue growth at the cost of substantial business failure. With the turn in the economy, there is an expectation of more growth off high bases, without the actual cost being measured and adjusted at negotiation time.

DIFFERENT OCCUPANCY COSTS FOR DIFFERENT BUSINESSES

Every business is different, although there may be some similarities, and income, gross profit and expenditure patterns change according to the type of outlet.

There are some 45 to 55 different retail operations. Depending on the product mix (determined by consumer demand in different catchment areas) and the competition within the tenant mix, two apparently similar businesses may differ quite considerably. The product mix is also influenced by the permitted use clause. This may result in higher turnovers but lower gross profits for one operation and the exact opposite for another. A seemingly minor change in usage can significantly affect a business profile and its viability.

Naturally space requirements in a shopping centre differ. While there are definite trends in the major industries, there may also be significant variations between different types of businesses. For this reason, different tenants cannot pay the same level of rent if two are bidding for the same floor space. Size, frontage, permitted use, location and potential are not the only means determining the current market rent. It is more complex than that. Owners have an intimate knowledge of their businesses and how they perform. Good retailers will also try to maximise profit (turnover and margins).

Valuers doing a determination or land economists negotiating a lease cannot simply rely on the owner's rent roll to arrive at current market rent; they must talk to both parties to the contract. Only similar types of businesses can be used when determining rentals, making adjustments for size and frontage and including the business profile and ability to pay rent.

New legislation in Queensland, New South Wales and South Australia dictates how a valuer should assess the current market rent. This must be done on the basis of what someone would "be reasonably expected to be paid for a shop if it were unoccupied and offered for renting for the use to which the shop may be put under the lease". The use of the word "may" implies highest and best use, "will" implies permitted use, because the negotiating parties know what type of business they are dealing with when negotiations commence. A fruit shop does not expect to pay the same occupancy cost as a jewellery shop and survive as a long-term tenant.

The examples in Tables 1 and 2 compare high and low gross profit margin businesses. A jeweller and a fruit and vegetable shop are used (the latter's margins and revenue are falling because of intense competition from the majors). It is assumed that they occupy two identical outlets and, by maximising their potential, achieve sales of $400,000 per annum.

Table 1 illustrates the profile and the level of rent each could afford to pay to make a return on capital, do five-yearly fitouts, pay fair wages and salaries, etc.

The jeweller, with a similar turnover to the fruit and vegetable shop, theoretically could afford to pay more than double in occupancy costs. Phillip Willington[4] suggests a fruit and vegetable shop should pay a base rent of 3-5% of sales; a jeweller 7-10%. (These percentages are applicable today although because anchor tenants are taking a larger slice of speciality shops' market share, they are more critical.)

Assuming both occupy 75 square metres, this means that the jeweller could pay $40,000 or $533 per square metre and the fruit and vegetable shop $20,000 or $267 per square metre per year. The fruit and vegetable shop definitely does not have the same affordability level that the jeweller has with lower margins. This is supported by PRACDEV Key Indicator Reports.[3] The authors of these surveys for practising accountants indicate for each business to be operating according to its profile, the fruit and vegetable shop could afford a gross occupancy of 4%, the jeweller 9%. The suggested rent levels are the same from both sources.

Another important point is that the value of a small item of jewellery could equal the value of the entire stock of the fruit and vegetable shop. Physically the nature of the businesses is quite different, hence calculation of rent on a per square metre basis becomes difficult to justify. Both outlets could be used for a jewellery shop, but the fruit and vegetable shop would not survive at the same rental levels.

THE TRADE OFF BETWEEN GROSS PROFIT AND TURNOVER

How then can both businesses afford to pay a similar level of rent? Table 2 shows the same businesses but uses different levels of sales.

Can one solve the problem by making sure the fruit and vegetable outlet sells double that of the jewellery shop, thus justifying the same rent per square metre? No. Physically the fruit and vegetable shop may be unable to sell any more product. The two shops cannot be expected to pay the same occupancy cost and remain viable. Using this example, the fruit and vegetable shop could afford, say, $350 a square metre at a 4% occupancy ratio.

At this stage the owners must decide whether they want a low margin, lower turnover business in the centre or whether they should replace it with another jewellery shop. They must also decide whether the fruit and vegetable shop enhances the centre and attracts customers who spend money in other shops. One would expect that a good fruit and vegetable shop would increase the traffic flow and, in most instances, add to the atmosphere of the centre. However, this type of trader requires more floor space, at a lower rent per square metre, to achieve the same level of profit as the jeweller.

Table 1

	Jeweller		Fruit and vege shop	
Annual sales	400,000		400,000	
Less cost of sales	192,000		264,000	
Gross profit	208,000	52%	136,000	34%
Less major expenses				
Wages and salaries	88,000	22%	80,000	20%
Available for other expenses including occupancy costs	120,000	30%	56,000	14%

Source: PRACDEV[3]

Table 2

	Jeweller		Fruit and vege shop	
Annual sales	400,000		800,000	
Less cost of sales	192,000		528,000	
Gross profit	208,000	52%	272,000	34%
Less major expenses				
Wages and salaries	88,000	22%	160,000	20%
Available for other expenses including occupancy costs	120,000	30%	112,000	14%

Source: PRACDEV

OTHER CONSIDERATIONS

There are other important points for an owner to consider.

First, the floor space used by some operations which have high storage/ preparation components, such as butchers, bakers, fruit and vegetable shops and fresh fish outlets, is dead space which earns no direct income. This is further proof that using the same rent per square metre is inappropriate and supports the contention that all things being equal, no two businesses can afford the same level of rent.

A second point is the introduction of new competition into a centre. This is linked to healthy versus unhealthy competition. The difference between profit and loss in a lower gross profit margin business is minimal; there is little margin for error. Without careful monitoring, a second fruit and vegetable shop could be the death of one or both shops.

The ratios between turnover, gross profit and profit are highly sensitive. From the remaining 14% (Table 2), major expenses have to be deducted. They include occupancy, electricity, insurance, depreciation of expensive plant, machinery and motor vehicles, new fitouts and return on committed capital (including stock as there is an opportunity cost involved). Occupancy costs of 10-12% mean the fruit and vegetable shop's existence is terminal. Yet in a free market economy, traders do not knowingly go into business to fail. Hence they are fully justified in addressing their expenses openly and impartially with owners and managers. It is in the long-term interest of both parties, particularly the owners.

The third consideration is the manipulation of gross profit margins. The term "value adding" is a marketing concept. The idea is that if customers perceive additional value, they will pay more for the goods or services. This enables the trader to charge more, to increase the gross profit and, ultimately, their bottom line figure. Of course the target market should be able to afford the higher prices of the value-added product.

Individual traders are best positioned to decide whether price sensitive goods or services would meet consumer resistance. If turnover falls, there is no additional profit and the objective is defeated. Most good retailers want to maximise income and profit, and they also know their businesses. There is little a property practitioner can do unless they are proven retailers with a lot of experience.

Making sudden changes without cash flow and capital is risky and could be detrimental to the business. The property professional may be dealing with a high gross profit type of business, yet the affordability level may be quite low. For example, a bread shop is very labour intensive and the capital cost is very high. The opportunity cost to get a return may be to invest in the bond market where you can be assured of getting your money back after five years.

Coffee lounges and restaurants have high gross margins but carry a very high labour component. Take-away operations have lower gross profits and wage costs.

Businesses typically have fixed and variable costs. A fixed cost is base rent and a variable cost is turnover rent. At a particular level of sales, once both are covered what remains is profit. Variable costs, such as wages, increase with sales.

Businesses able to achieve super sales can afford to pay slightly more rent if they are more efficiently run, but why not let a turnover clause do that? Quite often this may be a new idea which is fashionable at the time. One should remember that these businesses tend to have quite short industry/product life cycles.

Similarly, introducing an innovative retail outlet could severely jeopardise the viability of the existing tenant mix in a certain category. Without sufficient cash flow and capital, retailers may be unable to re-position their business to react to introduced competition. Proactive practitioners should advise owners of the danger rather than waiting for the inevitable to occur. They may even instigate re-negotiating the financial terms of an existing lease.

FRANCHISED OPERATIONS AND THEIR EFFECT ON OCCUPANCY COSTS

Franchised businesses are the flavour of the moment. Lessors like the double security of having the franchisor as tenant (with signed guarantees) and the franchisee on a licence (also with guarantees in place). Advantages include the enhanced image of a national

chain and the resultant promotion of the centre. However, this can mean the loss of "local flavour". The term "generic shopping centre syndrome" becomes quite apparent.

High franchise fees and promotion costs (some as high as 14%) mean profit margins drop significantly. The gross profit margin may fall from 45% to 30-31% which means there is less to meet to the operating expenses, including occupancy costs. Alternatively, sales must be more than doubled to afford the same occupancy rate. If everyone becomes a franchise operation, will the whole centre's sales double to cover those costs?

The term "leverage" comes into the equation, and it is one which is difficult to explain. The rent of a supermarket paying 1.5% of sales to occupancy doubles if it pays 3%. At 1.5% the operation could be viable, but at 3% it may mean a loss. This illustrates leverage and the importance of these ratios.

Table 3 illustrates two typical gift shops. One is privately owned, the other is a franchise operation paying 14% of turnover towards franchise and advertising fees. Unless sales increase, the franchised business cannot afford to pay the same level of rent as the privately owned business. These sales must come from existing tenants in the tenant mix, or their presence must generate new revenue into the centre. Alternatively, total franchise fees must fall to, say, 4-6% of turnover, with a smaller increase in sales – relating to leverage.

Other expenses include electricity, insurance, major travel expenses, five-yearly shop fits, stock holding costs, return on committed capital and centre promotions, etc. The recommended occupancy cost is 8% or $32 000. Clearly, the franchised operation will not survive. Franchisees will come and go, losing hard-earned capital in the process.

Table 3

	Private gift shop		Franchised gift shop	
Annual sales	400,000		400,000	
Less cost of sales	220,000		220,000	
Gross profit	180,000	45%	180,000	45%
Less franchise fees plus advertising at 14% of sales			56,000	14%
Effective gross profit	180,000	45%	124,000	31%
Less major expenses				
Wages and salaries	92,000	23%	92,000	23%
Available for all expenses including occupancy costs	88,000	22%	32,000	8%

Source: PRACDEV[3]

IMPLICATIONS OF LEGISLATION

The Trade Practices Commission has recently flexed its muscles quite successfully with major organisations in Australia. Also, there have been major papers on retail property that highlight some quite significant problems.[5] No longer can a party with superior negotiating ability go for growth, at all costs, to meet unrealistic budgets.

New retail legislation calls for far greater disclosure, which tenants are entitled to demand (or refuse to pay).

Owners and managers have full control over all aspects of the properties they manage. As well as knowing the rent traders pay, they receive monthly turnover figures of all the traders. They control tenant mixes and tenant numbers in all categories. Representative bodies publish figures on what different types of businesses can afford to pay as a percent of turnover. It is quite easy to monitor rent ratios on a monthly basis.

Large national owners/managers have the the necessary information to predict what will happen to remaining tenants if a particular operation is introduced into a centre. The results, as previously stated, can be devastating. Owners/managers will have to be more proactive in their decision making and re-negotiate lease terms (even in the middle of a lease).

There is a tendency to put good operators out of business in the name of sound commercial practice, blaming the tenant's non-performance. There are many variables over which a tenant has no control. These are fairly and squarely in the hands of an owner/manager.

LIMITED FIVE-YEAR LEASES

Often, for businesses to be profitable, rental levels need to fall back in line with recommended levels. If owners and managers want only five-year leases, with the threat of non-renewal, for tenants to make a return and vacate in that period, rents will have to drop even further. Full fitouts every five years and relocations are also quite unrealistic – it is easy to spend other people's money.

Alternatively, to prevent even lower rent levels, leases with option periods and more certainty of tenure could be offered.

CONCLUSION

Tenants in occupation know they have to pay rent and good retailers know what their businesses can afford. When doing a comprehensive analysis to assess a business profile and decide on the performance of the operation, most retailers can suggest a level of rent that corresponds with the turnover percentages available.

Unless the property profession once again embraces the policy of free and fair negotiation across the table between willing informed parties to the contract, the Trade Practices Commission, and tenants, will have very good reason to pursue actions against owners and managers. Every time a business fails, the cost to the community – both direct and indirect – is high.

Valuers and land economists as impartial professionals can enhance the process of free and fair negotiation. Let us not be scapegoats with no defence for not demonstrating that we have been proactive and professional.

FOOTNOTES

1. Rae Kaspiew: "Shop Standoff", *Property Investor*, BRW Publications, August 1994.
2. Gothard, K: "The Valuer's View", *The Valuer & Land Economist*, August 1994.
3. Cleland, Dr K. and Watters, T: PRACDEV Key Indicator Reports, 1994-95.
4. Willington, P: "Determining Shopping Centre Rentals", *The Valuer*, October 1987.
5. Millington, Prof. A.F: "Retail Property in Australia", January 1995.

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The author has experience in marketing (fast-moving consumer goods and industrial products), leasing, valuation and portfolio management in South Africa. He migrated to Australia some six years ago and after working for a number of property companies, two years ago established his own consultancy, SA Lease Negotiation, in Adelaide. He is a consultant for the Small Retailers Association of South Australia and has been involved in the negotiation of the Retail Shop Leases 14 of 1995 in South Australia. □