

**MATCHING MARKET DEMAND TO SUPPLY OF RETAIL SPACE VIA MORE  
ACCURATE MARKET RENTAL VALUATIONS FOR MORE EFFICIENT  
DEVELOPMENT AND USE OF RETAIL SPACE**

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**17<sup>th</sup> Pacific Rim Real Estate Society Conference: 17 – 19<sup>th</sup> January 2011, Bond  
University Mirvac School of Sustainable Development, Holiday Inn, Gold Coast,  
Queensland, Australia**

**Table of Contents**

<b>Abstract</b>	<b>2</b>
<b><u>Graphs: Attachments and in body of report</u></b>	<b>3</b>
<b>A. Overview – damage to Intangible Asset Value of leases in Australia through leasing practices and Government protection to the detriment of all stakeholders</b>	<b>3</b>
<b>B. The Key Performance Indicators of the operator and business performance – see Graphs 1 &amp; 2 (attached and also in body of the paper). This is the actual recent case study from which this methodology crystallised</b>	<b>8</b>
<b>C. The activities and procedures or the “process” which the valuer should follow to assist him in ranking and processing data under the GEM Method – see colour coding</b>	<b>10</b>
<b>Step 1. One method of testing the competence of the hypothetical operator</b>	<b>11</b>
<b>Step 2. Linking and ranking known performance levels of the subject, relative to other directly comparable businesses, other stores (if applicable) operated by the operator, major competitors, benchmarks, etc.</b>	<b>11</b>
<b>D. The market rent and findings from market evidence - see Graphs 3 to 5; noting that this method works equally well for high performing sites</b>	<b>14</b>
<b>Step 3. Linking and ranking the occupancy costs of the subject business, known “tested” evidence, suggested or purported and industry benchmarks</b>	<b>15</b>

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<b>Step 4. The linking and ranking of purported evidence, the existing and proposed rents of the subject tenancy, with evidence in the market, including key competitors, benchmark equivalents and an “average” of tested evidence in a store of equivalent size as an annual sum</b>	<b>16</b>
<b>Step 5. The linking and ranking of the purported evidence, the proposed and current rent being charged, including the rent paid by major competitors, known comparables, benchmarks and “averaged” comparable rent, expressed as a percentage of turnover and equivalent \$/M2</b>	<b>17</b>
<b>E. Benefits and conclusions</b>	<b>21</b>
<b>FOOTNOTES</b>	<b>25</b>

**Please Note:** all material in this paper and presentation is fully supported by independent research and fact obtained by the Author.

## **Abstract**

**“The Gilbert Evaluation Method (‘GEM Method’) of assessing current market rent” clearly links reasonable site productivity, to evidence in the market place to assist one to form an opinion of what the “current market rent” is”.**

This paper describes how the GEM Method works. In effect it is a “valuation” system or a set of activities and procedures, which sets out a methodology for professional practitioners and industry stakeholders to use to assist them to arrive at the “current market rent” more accurately. It references and cross references a series of data (the rental “evidence”) including suggested or purported evidence and assists one to sort the data out into what might be “reasonable” and or “unreasonable” rent. It avoids random outcomes as it has a disciplined set of activities and procedures to follow.

The evidence (including the subject tenancy) can be referenced and cross referenced to site performance and independent benchmark reference points. In so doing it does not lessen or reduce the expert valuer’s role, it in fact enhances it in a step-by-step process to arrive at meaningful conclusions what the current market rent might be. From then on a valuer is in a better and more informed position to make a more accurate assessment or determination of the current market rent (depending on his role).

Independent valuers are in a better position to obtain data such as turnover levels, that is required for this system to work.

Furthermore the graphically presented data is colour coded to assist the valuer (or reader) for analysis purposes, and to siphon the material in regard to what might be relevant or irrelevant. As one processes and analyses each step, the “reasonable” rent becomes evident from a site productivity point of view, in regard to the total annual rent for a shop of equivalent size to the subject tenancy and as a dollar per square metre rate, assuming the actual stores annual turnover.

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This paper is a “case study” for a shopping centre rental assessment for a supermarket (the key anchor tenant) in a regional town in country Australia.

Lastly a valuer can use the “Hypothetical rent as a residual method<sup>i</sup>”, similar to a development method by obtaining Financial Statements over say a three year period, either as a “check” or primary method eg. where no meaningful comparable data is available to assess the current market rent of a retail store being operated at to “reasonable” industry standards.

The system can be used world-wide with the major benefit in that valuation of retail and income producing property will be significantly more accurate.

### **Graphs: Attachments and in body of report**

- Graph 1:** Graph 1, shows the proprietor having operated other supermarkets/convenience stores on opening or assuming ownership of a business, then performance levels, either current or on selling the business, shown as annual sales.
- Graph 2:** Graph 2, shows the annual sales per square metre versus other supermarket benchmark averages, comparable outlets in the market, i.e. non-metropolitan. Other stores operated by the tenant are shown in light blue, noting further evidence of reasonable competence of the operator.
- Graph 3:** Graph 3, shows comparable occupancy costs including subject businesses' current and proposed rents, plus consequence of rents proposed by landlord (shown in green using actual sales to arrive at an applicable occupancy cost).
- Graphs 4:** Graph 4 links the actual and suggested rental evidence of each store to a similar size square metre equivalent to that of subject. The annualised rent is shown based on the evidence.
- Graph 5:** Graph 5 links the resultant occupancy cost<sup>ii</sup> of a store trading at the same level as that of subject if the “evidence” is applied to the subject. Only the far red bar graph would satisfy criteria for “reasonable” rent required under Retail Shop Leases Act.

### **A. Overview – damage to Intangible Asset Value of leases in Australia through leasing practices and Government protection to the detriment of all stakeholders**

The Australian Real Estate Investment Trusts ('A-REITs') weighted to the retail property sector has collapsed. There are still significant structural imbalances in

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this sector. As it is embedded into the contractual obligations of a long-term asset class, this problem will take years to rectify. Even if Governments fixed the State tenancy laws.

An aim of this presentation is to give a brief overview of:

1. The factors that have lead up to the collapse of the 'A-REITs' and the wider property industry and the significant affect it has had on investors, financiers, valuers, etc; and
2. To look for solutions to prevent this from occurring again in the future<sup>iii</sup>.

One can easily be critical of industry behaviour. It is preferable, however, to seek constructive solutions and thus prevent spectacular and unnecessary "crashes" in the future, reasonable fluctuations in the markets aside.

The author has concentrated energies during a long property career towards:

1. Better and more informed lease negotiations;
2. Adding value to leases via better and more flexible lease and rental structures and reasonable tenure (consistent with Australian Accounting Standards ('AASB') 138, or International Accounting Standard 38 – see below);
3. Adding value to retail precincts by encouraging better tenancy mixes, improving customer traffic and market share in a given market by segmenting any given market;
4. Suggesting the matching of leases and rents to true market rent by reference to trading profit potential, rather than "gambling" with leases at inflated rents, resulting in vacancies and fluctuating (and lower) overall or weaker income streams;
5. Suggesting fewer "incentives"<sup>iv</sup>, but rather lease and rent structures which have less impact on the cash-flow of a subject business, that erode quality of rental income streams at later stages in a lease; and
6. Legislation that is less complex, but which triggers end of lease or lease rent dispute resolution mechanisms (regular reviews to current market rent) to adjust for imbalances, that may occur in the market. The Shopping Centre Council have rigorously defended this; they would lose "control" even if it would allow a more open and transparent market to operate for the benefit of all stakeholders.

Having attended a recent (and very well presented) Australian Property Institute Retail Lease Forum, sponsored by the Queensland Valuers' Registration Board, it is pleasing to note that there are some signs of the industry shifting towards "adding value" to leases. No doubt this is due to AASB 138, which will compel all stakeholders to take into account, whether valuing one lease or a bundle of

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leases. Longer, better, well structured, economically sustainable, and more flexible leases add market value to both an individual lease and a “bundle of leases” i.e. a whole investment property.

The biggest challenges appear to be twofold. Firstly, inertia to change from within the profession (a failure to see beyond a rent on a dollar per square meter basis of analysing and calculating rents ('\$/M2')<sup>v</sup> with “random” outcomes and linking it to “reasonable” rent on a sales productivity basis to satisfy state tenancy laws and the current market rent definition) and, secondly, poor perceptions and ruinous outcomes and experiences of parties<sup>vi viii</sup> when valuers get it wrong.

To this end at this point, one might ask, if there were two supermarket based shopping centres trading alongside one another, what is the current market rent of say the newsagencies in both centres? The one centre is dysfunctional by design and tenancy mix. The supermarket draws traffic and trade worth \$20 million against the other centre, which trades at almost double that.

Assuming a Specialist Retail Valuer<sup>ix</sup> ('SRV') is required to determine the current market rent under state tenancy legislation for one of the newsagents in the centre whose anchor trades at double the amount of the other. The other's lease has just been negotiated in an arms-length transaction. It trades at only 55% of the level at which the other notionally trades. The arms-length negotiations were negotiated by both parties referring to FMRC Business Benchmarks for newsagencies as a reference point.



Would the SRV not do the stakeholders of the second centre a significant disservice if he simply transferred the same equivalent rental rate (\$/M2) to the centre who trades at much higher levels than the subject premises?

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One also needs to consider different scenarios:

- A six month vacancy over a five year lease for a property whose market rent is +20% too high, excluding other associated expenses, it could quickly blow out to a 20 to 40% reduced return over five years for example;
- An 18 month vacancy over five years can quickly blow out to 40%+ decrease in potential income if one is covering outgoings as well, (set-up costs and other refurbishments and obsolescence factors aside); and
- The damage that can be done to remaining businesses as traffic flows decline and or physical damage to a partially leased property which may become a “dead mall”, etc.



Landlords (and their agents) often argue that it is preferable to let their properties remain vacant rather than “devalue” them by accepting lower offers from tenants, with certain income streams. Those owners then are then forced to cover statutory and other outgoings while a property is vacant.

A simple consequence of over-rented buildings and properties is the signal that is sent to developers is to add more stock on to a given market, making it “supply driven”. Supply driven development may add more supply to an already saturated market (well before a given market calls for it). It might end up to be duplication or triplication of the same and therefore cannot be environmentally responsible. Demand driven development is environmentally friendly with demand better matching supply as and when it is called for.

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There is ample evidence of this community waste of landlord, tenant, and human resources capital, because the market is dysfunctional.

The point being made here is that well leased properties have consistent but steady income streams and, on average, generate better and steadier returns over time. Rental income streams that cannot be or are not supported by adequate custom and turnover levels contribute to business failure. In my view this is a costly way to grow a given economy.

The structural imbalances built into the financial aspect of the shopping centre industry as mentioned, where a large proportion of leases are "over-rented" will take years to correct as it is a long-term asset class.

To this end the "The GEM Method of assessing current market rent" has evolved and this "valuation" system or a set of activities and procedures links site productivity to market rental evidence, relative to the specific site in question. Adjustments can then be quantified and applied in order for the "reasonable" rent to be assessed or determined.

To comply with Australian Accounting Standards 138 (AASB 138)<sup>x xi</sup>, the legislation, etc. adjustments should be made for essential lease terms such as tenure, lease flexibility, etc<sup>xii</sup>.

The important aspect in regard to the GEM Method is that it does not change existing methods of valuing the leases of special purpose income producing properties eg. Motels, businesses, or shares it simply refines existing methods and strongly links "tested" evidence in the market place to the shop, business, or tenancy in question. In other words it reduces subjectivity and it makes it a more objective exercise.

The methodology has been "stress tested" for high and low productivity sites and is extremely useful.

In my experience this is an area where some Specialist Retail Valuers can err and or fail when making determinations. After obtaining evidence , determinations fail "reasonableness" tests<sup>xiiixiv</sup> because they are swayed, being preoccupied with dollars per square metre "\$/M2", without considering the total annual rent including outgoings for the site, relative to site productivity, which can vary with different competition, profit margins, socio-economics, profit margins, existing lease terms, tenure and management quality (landlord and tenant).

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The benefits of the above approaches are as follows:

1. Better and "tested" rental valuations linked to site and location-related to performance;
2. Optimised investment in landlord's and tenant's capital linked to market demand;
3. Better allocation of finance to the sector;
4. Better and more efficient "supply" to a given market, therefore less duplication of same and failure of businesses or property investments; this is a direct environmental benefit as well;
5. Better and more certain returns for investors and prospective investors;
6. At a more macro level less potential for asset "bubbles"; and
7. Better lease negotiations and informed outcomes and behaviours within industry.

Against this backdrop there is:

1. A better chance for asset valuers to value a property where current market rent which differentiates landlord and tenant interests by definition (not passing rent) is being paid;
2. Less chance for major property crashes; and it
3. Protects shareholder and mortgagee interests.

**B. The Key Performance Indicators of the operator and business performance – see Graphs 1 & 2 (attached and also in body of the paper). This is the actual recent case study from which this methodology crystallised**

A Specialist Retail Valuer working in the field, seeking to obtain "evidence", encounters other "experts" including other business owners, landlords and agents, dictate what the answer should be. The reasons are many and obscure.

One case, namely Robinson Bross dating back to 1937<sup>xv</sup> suggests otherwise. When one does a rental determination, the pendulum swings for many reasons, first favouring one party then the other as one carries out the analysis. The same occurs when providing expert advice for calculating loss for breach of lease.

What one is seeking to do is to estimate what objective willing informed parties agree on for say a three-year lease with two three year options or a lease of five years with one five year option, possibly with 3% per annum reviews or 5% per annum reviews, were the property vacant and available for lease under those terms.

What if options had fixed increments and increases at each option versus market reviews i.e. one is instructed to make a determination now in a business

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environment that is quite risky, for a lease with no lease/rent flexibility and which could only ratchet upwards over the next 10 or 15 years. Would the adjustment be higher or lower if a hypothetical tenant saw upside risk? It might be that the parties would choose to walk away from such an inflexible arrangement. The hypothetical parties are presumed to agree on terms that willing informed parties would accept in an open market, having regard for the lease terms.

That is where the skill and judgement of an experienced SRV comes into play. The SRV does not just look at the evidence, he considers these factors as well including the terms of the lease and makes adjustments for them (with reasoning and logic).

What about that same lease risk for basic food versus discretionary spending i.e. different permitted uses? And what about the same for different sites with different viabilities, even in adjoining centres? What of two like newsagents, mentioned above, one trading in a centre where the key anchor trades at \$38 million per annum, the other that is barely trading at \$20 million per annum?

And if one were a newsagent and the other a sub-newsagent? Including the scenarios mentioned above the permutations are many; but can be readily resolved with sufficient knowledge of all the factors, and KPIs of a properly conducted business under the specific lease.

Some agents, landlords and tenants “throw” a \$/M2 rate at a SRV (backed by their own theories of comparability<sup>vi</sup>) and tell them what in their belief the answer should be. There is an apparent belief that if there is a rental range of \$250 to \$500 per square metre (tested or untested for site performance), that “evidence” can be thrown at the store in question. In relative terms, this equates to “picking a number” or taking an “average” of two numbers and to satisfy the requirements of the various tenancy laws. What if a site is small and trading at very high levels and vice versa?

The starting position must be; is the current site trading at reasonable levels? Relative to what? Relative to this business over the last three or five years, relative to other businesses, relative to these types of businesses with this level of representation in a supermarket based centre, or a sub-regional or regional shopping centre, for this site in this location. What about the competition profile over the next five years? What about changing demographics, business cycles, and conditions when “comparables” first entered into leases in regard to dated evidence? What if the site is overtrading i.e. the operator’s personal goodwill which must be excluded from calculations? How does one measure that?

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What one is trying to do is link the “business” in question to what any other reasonable, “hypothetical” operator would pay, if the shop were vacant and available for lease.

That is not the current rent, or the asking rent or the rent that the tenant may have proposed during negotiations (although parties do proffer an offer to settle rental disputes, with or without proper advice, which may or may not have a bearing of what the current market rent might be).

Once the site and business performance levels are estimated and the evidence gathered, the SRV can then consider adjustments for example for a three, five or 10 -year lease, a lease with options, with or without market rent reviews, etc. a lease with 3 or 5% increments and make adjustments according to his skill and judgement.

So the starting point is and must be, would this hypothetical someone who is willing and informed but not anxious, pay the same (or a higher) rent for a 1,000 square metre site, that trades at \$3,500 per square metre or one that trades at \$15,000 per square metre? And that is anticipated to continue throughout the lease based on today’s knowledge and the notional necessity to fit out and start the “new” business? Surely not! The SRV would immediately fail in satisfying the requirements under the legislation, because what they should do is quantifiable.

At the time of leasing it may have been represented that the tenancy mix would include a variety of permitted uses and the lease was entered into on that expectation but, in reality the centre could not be leased up. There are only two quite large tenancies, a supermarket and the specialty shops have been merged into one for a discount pharmacist. The expected variety and higher customer traffic numbers will not eventuate. This dysfunctional centre is also competing against a large branded centre with good drawing power and a good mix of specialty shops. The SRV has some challenging decisions to make, in deciding to adopt “commercial reality” for rents in the now established centre, which trades at far lower levels than were anticipated.

The expectation that the supermarket would trade at \$10,800 per square metre by year five has never materialised. In effect, the store in the centre only trades at \$3,750 per square metre; well below industry benchmarks.

Is the lack of performance due to the operator or the centre?

### **C. The activities and procedures or the “process” which the valuer should follow to assist him in ranking and processing data under the GEM Method – see colour coding**

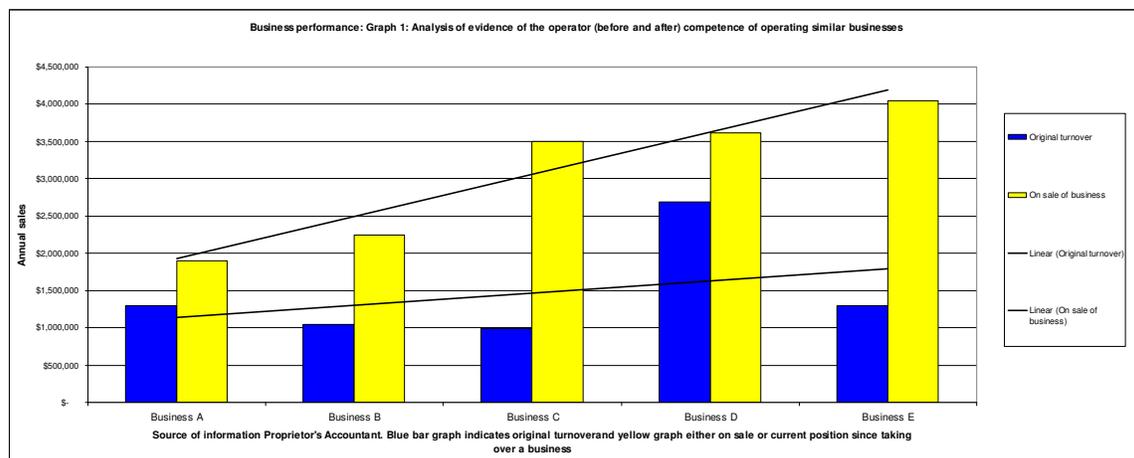
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## Step 1. One method of testing the competence of the hypothetical operator

Graph 1, attached and below, is one example of how one can start forming opinions regarding to the “reasonableness” of a given retail business.

The blue bar graphs show the level of sales the operator acquired or started with five businesses over different time periods on an annual basis and the yellow bar graph shows what they are currently achieving or the turnover achieved by the time he sold each business. Graph 1 below – is one method of assessing whether the proprietor is a reasonable “hypothetic” operator.

The trend lines indicate the growth achieved with regard to each business. This assists the SRV to form an opinion whether the operator is a “reasonable” trader (or not). However, there are many other “tests” that a SRV could and can do, which requires another paper.



## Step 2. Linking and ranking known performance levels of the subject, relative to other directly comparable businesses, other stores (if applicable) operated by the operator, major competitors, benchmarks, etc.

Graph 2 links the actual businesses turnover levels on a dollar per square metre basis (or a unit basis or \$/M2) to the other known evidence, some “best available” evidence and known benchmarks for comparison purposes.

The subject premises are shown in red. The operator and capacity to trade has been reasonably isolated and canvassed in Graph 1, therefore one can reasonably ascertain that there could be a problem with the centre, the management thereof, the catchment, competition or some other reasons for the businesses failure to operate at reasonable trading levels.

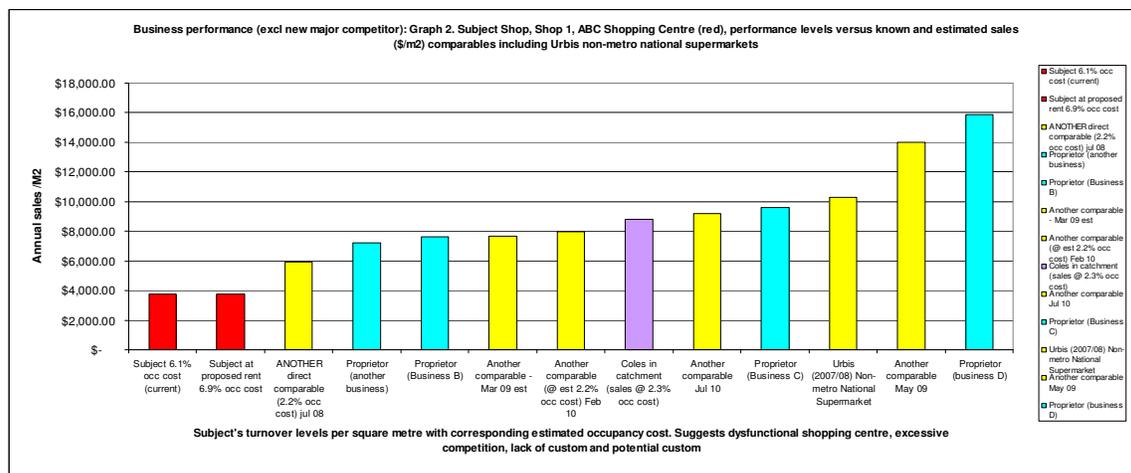
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An experienced SRV with forensic knowledge and experience of working with Financial Statements and feasibility studies eg. market feasibilities can produce a mini business plan and estimate the current market rent as a residual or rental assessment<sup>xvii</sup> if no comparable evidence was available, if the tenant was prepared to proffer the information. He could carry out other methods and tests to calculate gross profit margins for example and benchmark key operating expenses, sales trends and analyses, stock turns, other KPIs and capital costs.

Graph 2 – links the actual businesses turnover on a dollar per square metre basis (\$/M2) to other evidence and known benchmarks for comparison purposes

At this juncture, the SRV can start making some informed observations.

Graph 2 of the stores trading levels, compared to that of other stores, shows that, despite the apparent competence and track record of the operator, it appears unlikely that the centre can or will more than double or even treble its customer traffic and turnover to justify the current or proposed rent that the landlord considers is the current market rent. Notwithstanding the dysfunctional tenancy mix and representations about tenancy mix etc. at time of leasing.



This might be the first opportunity to have the rent reviewed<sup>xviii</sup> to current market rent as is envisaged in the legislation and under common law. A significant correction would be required and the SRV needs to be ready and prepared to make these adjustments.

The current sales per square metre that the store in the centre achieves are about 36% of the level of a Non-Metropolitan National Full Range supermarket such as Coles or Woolworths<sup>xix</sup>.

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Graphs 1 and 2 as mentioned show other stores currently and previously operated by the tenant. It is useful to obtain the source of evidence supplied and relied on by the tenant, noting the sales of another store by the operator (light blue) was almost \$16,000 per square metre versus \$10,264, that being the Urbis National Full Range Chain supermarket average (in yellow). The turnover is 55% higher than the national average, as evidence of the operator's competence albeit from a smaller floor area. Written confirmation from the tenant's accountants might be called for to support what has been proffered.

Graphs 2 (and 3) clearly show the store in question's (two red bar graphs) turnover per square metre, compared to other comparables which are extremely low (a reflection on the performance of the centre with poor tenancy mix, lack of custom, current competition relative to lack of population in the catchment and excluding new competition, namely Woolworths, that had recently been announced).

Graphs 1 and 2 are further summarised and illustrate the following:

1. From Graph 1, the blue graphs show performance levels as annual sales of four businesses (previous or current) owned and operated by the proprietor when he purchased or started each outlet;
2. The yellow bar graphs show current sales or the turnover when the business was sold. The trend lines are illustrative of the growth factors and suggest "reasonable" competence;
3. In each example, the tenant has been able to grow the turnover from 35% to 254% above its starting point;
4. There are many other KPIs that can be measured as evidence of reasonable competence, including shopping centre reference data;
5. Under each heading is the equivalent turnover per square metre, eg. when he sold the business;
6. The highest turnover achieved was \$15,882 per square metre - 55% above the national average as mentioned;
7. From Graph 2, the yellow bar graphs show estimated turnover levels obtained of stores and provided as comparable rental evidence. The purple bar graph shows the equivalent sales per square metre which Coles must be achieving in order to pay around a 2.3% occupancy cost i.e. a direct competitor – ref Lease Information Services data base;
8. The red bar graphs clearly show the current annual sales of \$3,750 per square metre, currently a 6.1% occupancy cost and the Landlord's proposed suggested gross rent being a 6.9% occupancy cost is well above industry benchmarks, particularly for businesses in country areas;
9. The business presents reasonably in the centre. Naturally there are signs that it is under "stress" as evidence by analysis of the KPIs from the audited Financial Statement. At lower turnover levels, stock deteriorates and

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- spoilage increases which depresses margins, however the store and shop need to look "full" and "fully stocked" so that custom continues to return;
10. To compete with and pay the Coles estimated occupancy cost of 2.3%, at the landlord's suggested gross rent of \$246,844, the store needs to trade at \$10,7 million per annum, or 200% higher than its present levels. This excludes the probable fall in trade, that will occur when Woolworths opens in the catchment.

The Business Plan before this lease commenced, shows that at this point the subject tenancy should be trading at \$10.3 million, not \$3.558 million (34.5% of estimated levels or \$3750 per square metre). As mentioned, Non-metropolitan Supermarket Based Centres trade at \$10,264 per square metre on average whilst the subject trades at 36.5% of those levels. At lower potential income levels, a business then needs to recover and pay for fixed overheads such as fitout, eg. fixtures and fittings. Recovering a disproportionate fixed cost becomes more difficult at lower trading levels and to still trade as a viable entity.

This is another strong pointer to the fact that, if trading levels are around 1/3 of national benchmarks, so rent (a fixed cost) levels should also be adjusted by at least the same amount if not more, and because it is a fixed cost (see pharmacy rent which is another useful pointer below).

It is for these reasons that Market Rent Reviews are built into leases, for genuine upwards or downwards adjustments in the rent. In carrying out this exercise, there appears to be no support for an upward movement in the rent, but rather it suggests a strong downward movement.

#### **D. The market rent and findings from market evidence - see Graphs 3 to 5; noting that this method works equally well for high performing sites**

Collation, correlation and relation of:

1. The current rent being paid, relative to current turnover levels (business opportunity) in the centre; and
2. As above regarding the proposed rent being paid;

There was good recent evidence for supermarket businesses in non-metropolitan towns (total and on a \$/M2 basis) and also, in some cases, the estimated turnover levels which helped establish "reasonableness" of corresponding occupancy costs<sup>xx</sup>.

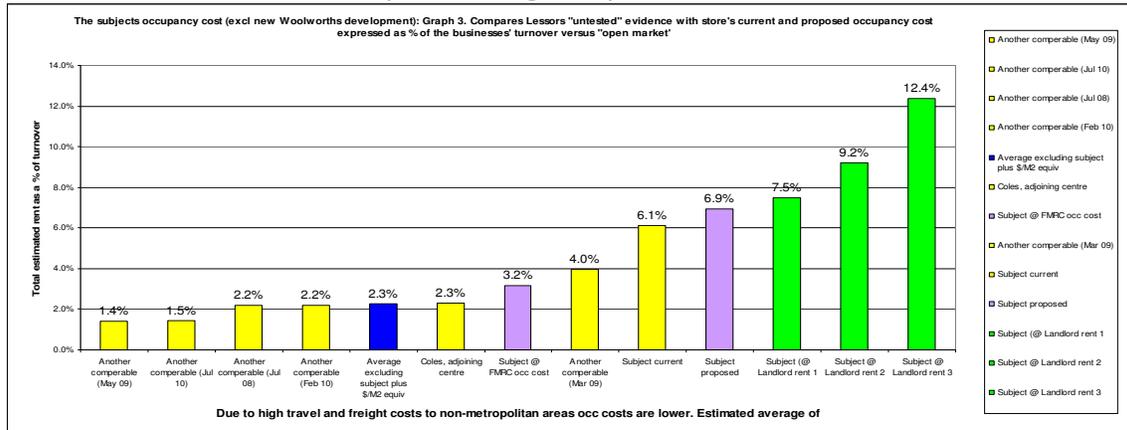
The SRV can then impute rental rates of this evidence into a 949 square metre equivalent shop to illustrate whether one might regard the rent as being

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“reasonable rent” by showing it as a percentage of current turnover (in 2009/2010 that was \$3.558 million or \$3,750 per square metre).

### Step 3. Linking and ranking the occupancy costs of the subject business, known “tested” evidence, suggested or purported and industry benchmarks

Graph 3 - looks at evidence on a gross occupancy cost basis as a percent of sales and the Landlords suggested evidence expressed as a percent of the businesses actual turnover (shown in green).



Graph 3 illustrates the following:

1. The first five yellow bar graphs represent the estimated occupancy costs as a percentage of sales for supermarkets under various Australian supermarket banners in country towns of recent leases negotiated in arms-length transactions;
2. The occupancy costs range from around 1.5% to 4.0% and the average is shown in blue, i.e. 2.25% rounded up to 2.3%;
3. The subject tenancy is shown at the FMRC Business Benchmark rate for supermarket businesses that would equate to 3.2% of turnover for illustrative purposes. It is the first graph shown in purple;
4. It should be noted that non-metropolitan stores have significantly higher freight costs and this reduces their ability to cover costs and pay high rent levels, eg. above 2.5%. It is estimated that Coles pay 2.3% in the adjoining centre. The lease states that there is a turnover rental clause set at 2.5% of turnover;
5. The subject tenancy's current gross rent as a percent of turnover is also shown in yellow and the proposed rent in purple at 6.1% and 6.9% respectively;
6. The green bar graphs show the actual rental rate (\$/M2) for a 949 square metre store (the subject's equivalent), supplied by the landlord and suggested as current market rent (as evidence). The corresponding

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occupancy cost that would result based on the current subject store turnover is shown above each graph;

7. The suggested "Landlord rent 1" would equate to 7.5% of the subject store's sales of \$3.558 million, Landlord rent 2, 9.2% of sales and the 299 square metre store suggested as evidence and shown as "Landlord rent 3", would be 12.4% of turnover (see graphs 4 and 5).

Clearly, from this evidence, a "reasonable", well informed party who had a Business Plan and was contemplating a new lease would not consider starting up a business in the centre. Such a person would have/could:

- Had access to five years commentary from the Tenant's business broker as to why the business has not been able to be sold despite excellent lease tenure (see below);
- Had actual trading figures to use for profitability and KPI analysis; and
- Visit the centre noting the pharmacy, with discount signs on the walls. He would also have to invest over \$1.5 million to start up a similar business when small business finance is not available, and be aware that Woolworths are also opening a new store in the area.

A Woolworths senior manager informed me that they always experienced the order of a 20% loss of trade in year one of another major store opening in the same catchment and it is likely that the same could be expected by the subject tenancy, except in this instance, I believe that there will be a surplus of supermarket floor space for the population that can be supported.

It is suggested that the above criteria would be starting position in calculating what the current market rent is for this shop.

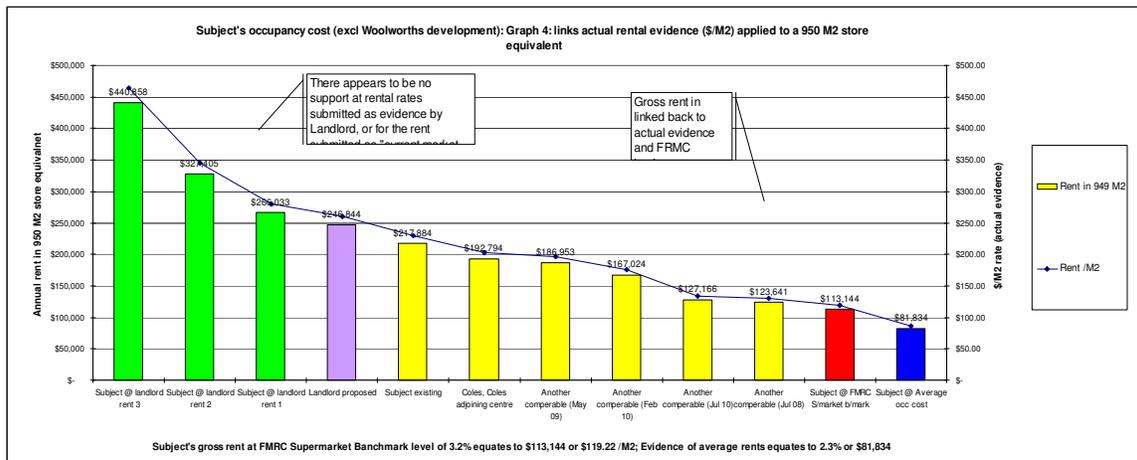
**Step 4. The linking and ranking of purported evidence, the existing and proposed rents of the subject tenancy, with evidence in the market, including key competitors, benchmark equivalents and an "average" of tested evidence in a store of equivalent size as an annual sum**

Graph 4 (see below) links the rental rate of the comparable outlets, including the rent suggest by the Landlord as current market rent. Each rate (\$/M2) is applied to a 949 square metre store; the corresponding annual gross rent is shown above it:

1. The green bar graphs show the Landlord's proposed rents, with the corresponding amount above each one;
2. The yellow bar graphs is the actual evidence which includes reasonably recent leases negotiated in country towns for branded supermarkets;

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- The rents currently paid and proposed for the subject are shown in yellow and purple;



- The red bar chart shows the equivalent gross rent the subject tenancy would or should pay, based on the leading FMRC Business Benchmark rate of 3.2% for supermarkets (equates to \$113,000 per annum). The blue bar graph shows the estimated average gross occupancy costs for the six stores, adjusted for the subject tenancy (equivalent to \$81,835 per annum) or a 2.3% occupancy cost.

This shows a strong link of evidence from the market place to the subject tenancy, trading at the level of sales a reasonable hypothetical operator could trade at in the subject shopping centre.

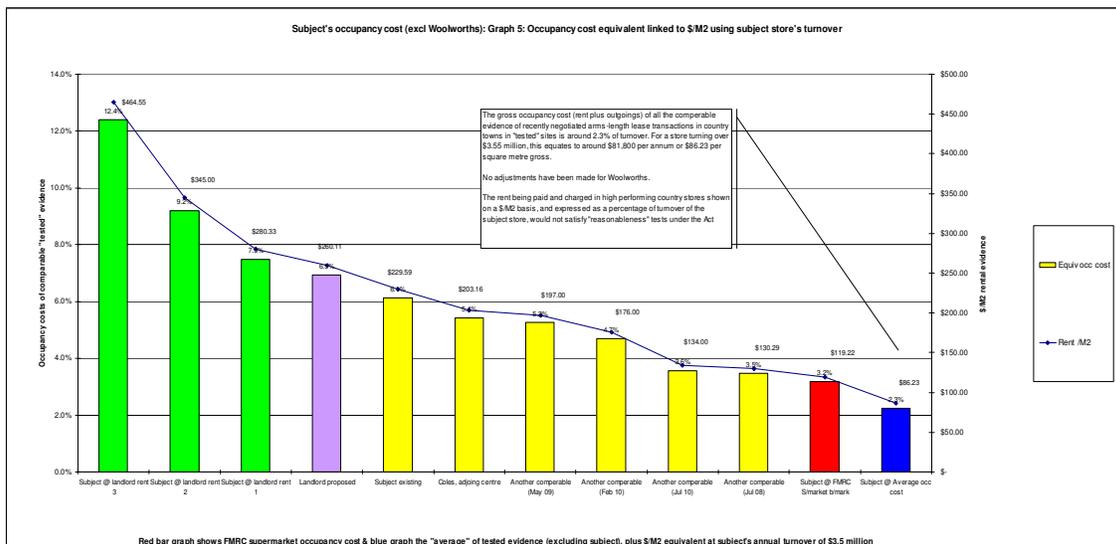
The last bar Graph, Graph 5, links the equivalent rental rate to the percentage occupancy cost which would result for a 949 square metre equivalent, gleaned from all the evidence, including the current and proposed rental rates suggested by the Landlord as "evidence" of current market rent. Other than the Coles data, the comparable evidence is confidential, hence for the purpose of this paper each one is described as "Another comparable".

**Step 5. The linking and ranking of the purported evidence, the proposed and current rent being charged, including the rent paid by major competitors, known comparables, benchmarks and "averaged" comparable rent, expressed as a percentage of turnover and equivalent \$/M2**

Graph 5 (see following page or enlarged attachment) – links the equivalent occupancy cost on a \$/M2 to the subject assuming projected sales of \$3.558 million.

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The following has also been obtained in regard to the evidence starting from left to right – see below:

1. The first three bar graphs shown in green represent the “evidence” submitted by the Landlord;
2. The first store was for a 299 square metre store. The equivalent rental rate was almost \$465.00 per square metre. No lease commencement date was given, nor the basic lease details such as tenure, review mechanisms, etc. If one applies the rental rate to 950 square metre equivalent at the projected turnover of the subject, it would equate to an occupancy cost of around 12.4% of turnover;
3. Another store in a country town has a “captive market”. The store adjoins the total “tenancy mix” being speciality shops that one might find in a small country town. All custom and potential custom coming into and leaving the town passes the business. The 7 year lease terms (information obtained by me) commenced in March 2009. Given the size of the town it is unlikely that another competitor would set up a store. Their trading levels are already at the level that the subject believed they could achieve (close to \$10 million - almost 200% higher than the subject). The gross rent is high, i.e. \$303 per square metre. The Landlord submitted the same evidence as “market rent” and that he believes the rent is \$345 per square metre (often evidence can be conflicting). At higher levels of rent in a captive market, i.e. less competition where one can charge more, one can sustain a higher gross occupancy cost of sub 4% of turnover. Given this is a new store, without testing other KPI's it might not satisfy “reasonableness tests” of being current market rent. The store in question also has potential for excellent growth; the subject in question the

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- opposite. If this rental rate is applied to the subject tenancy it would equate to a 9.2% occupancy cost;
4. The third supermarket submitted as "evidence" by the Landlord was for a store in a triple supermarket based centre, which is extremely well located in a large regional city. The centre has an extremely good tenancy mix. Substituting the rental rate of around \$275.00 per square metre to the subject would result in an occupancy cost of around 7.5% of turnover;
  5. The rent submitted by the Landlord as current market rent is shown in purple. It equates to \$260.00 per square metre and would almost equate to a 7% occupancy cost;
  6. The following bar graphs are shown in yellow which represent actual evidence. If that rental rate was applied to the subject store, based on the stores actual turnover of \$3.55 million, the corresponding occupancy cost (gross rent as a percentage of turnover) is shown above;
  7. The first yellow bar graph is for that of the subject business in the subject shopping centre. No further mention is required, except that the store is struggling to survive, it cannot be sold and has had almost \$1.0 million injected into it over the first five years of the lease simply to survive. The equivalent occupancy cost is 6.4% which is well above supportable benchmarks and or occupancy costs of comparable country stores;
  8. The following bar graph shown in yellow, which is for the Coles store. It pays around 2.3 to 2.5% of turnover (turnover rental clause) and it occupies 3066 square metres. This equates to around \$203.00 per square metre. If the Coles rental rate of over \$200.00 per square metre was applied to the subject store in the subject centre, the gross rent would equate to around 5.4% of the subject store's turnover. Cole's gross rent is self adjusting with the turnover levels. That centre has an extremely good tenancy mix. The 20+5+5+5 year lease commenced in 2000. To compete against a Coles, the subject store cannot have an equivalent occupancy cost of 6.1% or what is proposed, 6.9% of turnover; nor could it be considered that it pay what Coles pays of \$203.16 per square metre equivalent to say a 5.4% occupancy cost on a \$3.55 million turnover. This is further support, suggesting that the rent that Coles pays is not the "reasonable rent" for the shop in centre in question;
  9. Another banner store occupies a shop which is around 370 square metres. They also pay around \$200.00 per square metre, which would equate to 5.3% of turnover on a turnover of \$3.55 million. Either sales need to almost double, or the rent needs to be adjusted based on this evidence. The neighbourhood centre has an extremely good tenancy mix including Australia Post, Jenny Craig, Vision Australia, skin and beauty, bread, etc. The centre is well located in the town by comparison. The lease commenced in May 2010 and it is for 5+5 years with a market review in 2015. The rent is reviewed to CPI. Industry sources state that the turnover is X, which would mean that the occupancy cost is sub 2% of turnover;

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10. Another store's lease was negotiated in February 2010 for 10+5 years. The rent is reviewed at CPI 2-yearly. The gross rent for the 1500 square metre store is \$176.00 per square metre and the gross occupancy cost I understand is just over 2% per annum. The store is well located in the town centre, i.e. good tenancy mix. Trading at \$3.55 million, the gross occupancy costs would still exceed the averages of the independent businesses (estimated to be 2.3% of turnover) including the benchmarks);
11. Another store's lease in less than 500 square metres and has recently been negotiated for a 5+5 year lease. The store is well located with a good mix of custom around it in the CBD of the country town. When gathering the evidence it was submitted that the gross rent was sub 2% of turnover and the rent is \$57,000 per annum. If the rental rate of \$134.00 per square metre is applied to a 949 square metre equivalent, the occupancy cost of 3.6% is still excessive, noting that in less than 500 square metres it achieved higher sales than the 949 square metre store achieves, yet pays \$57,000 by comparison;
12. The following store rent pays \$130.29 per square metre. It was negotiated after the failure of the previous operator in July 2008. This is good evidence of an "arms-length" negotiation in a country area for a vacant shop available for lease. The 5+5+5 year lease's gross rent is fixed for the first five years. The gross rent for the 1650 square metre shop is around 2% of current sales, i.e. the rental unit cost. The operators of this and another store are very experienced. The gross rent is around \$130 per square metre and would equate to over 3.5% of turnover if that rate was applied to the subject shop at current turnover levels;
13. The red bar graph shows the gross rent as a percent of turnover of stores surveyed by FMRC. The gross rent paid by 75% of stores surveyed equated to 3.2% of turnover. 3.2% of the subject businesses turnover would equate to a rental rate of almost \$120.00 per square metre;
14. The last bar graph shown in blue was the average occupancy costs of all the evidence obtained (excluding the subject). That equated to around 2.3% of turnover, which if applied to the turnover of the subject would equate to \$81,800 per annum or around \$86.00 per square metre per annum gross. It should be noted that owing to the confidential nature of sales data, business owners often do not give accurate figures; however, by adopting reasonable questioning techniques, many will part with reasonably accurate information. It is beneficial if one is a SRV independent of an agency company.

Clearly therefore, if one took the rents at face value and imputed them in as "current market rent", it would equate to "ticking-a-number" unless related to the subject tenancy, which has been done in objective analysis thereof.

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None of the evidence above, which is recent evidence, relates to or can be related to the same or similar conditions under which the subject business trades under in the subject shopping centre. It can only be used if related to the same or similar conditions otherwise adjustments must be made to reduce subjectivity.

This I have now done.

It was mentioned above that the pharmacy leases space in the centre and its rental evidence is useful to consider. The pharmacy's rent was agreed to during negotiations in mid 2009 (subject to a market review) in an arms-length transaction. Whereas pharmacies usually pay a rental unit cost of \$655.00 per square metre in Non-metropolitan Supermarket Based Centres on average, the rent agreed to was \$275.00 per square metre on a unit cost basis. This equates to 42% of the average rent paid for pharmacies in non-metropolitan supermarket based centres. This rental rate negotiated in an arms-length transaction by quite a large pharmacy group with access to good data corroborates with the fact that I had formed an opinion that the supermarket in the centre in question trades at 1/3<sup>rd</sup> of the level it should be trading at, if the centre was fully functional.

As mentioned the recovery of "fixed costs" become disproportionate at low turnover levels i.e. this is a cost accounting exercise.

FMRC Business Benchmarks support a gross rent of 3.2% of turnover or \$119.22 per square metre trading at the same level the subject store trades at and the "average" rent paid for recently negotiated country stores was 2.3% of turnover or \$86.23 per square metre using the same basis of calculation.

As mentioned before, country stores pay significant freight costs. There is therefore less capacity to pay high freight, other store operating expenses and to cover rent in this instance, due to competition from Coles and Woolworths. Current market rent should be towards the lower end of the scale for supermarkets in country areas.

## **E. Benefits and conclusions**

Graphs 1 to 5 summarise and show that, in all probability, a reasonable, hypothetical operator would not take up a lease in the subject supermarket based centre and set up a supermarket in the current economic climate, even if no rent were charged.

Banks are currently not lending to small business and new competition from Woolworths in the area leaves no "room" in the market for a small supermarket business in a dysfunctional centre. One might consider a 200 or 300 square metre

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convenience store instead. But the lease is over a 949 square metre site, the 10 year lease term has a mid-term review built into it and the SRV must put his mind to what the current market rent is and make his determination. On the facts. Even if a significant variation is called for to satisfy "reasonableness" tests under the Act.

The performance and trading levels on a \$/M2 basis of the subject store is well below that of all comparables, national benchmarks and shops previous and currently owned and operated by the tenant (or the operator under different company names).

The occupancy costs (actual and estimated), including suggested industry benchmarks, are well below those of the subject and well below what is proposed. They are far below the evidence proffered by the landlord. The landlord has not linked them back to the store itself, which is shown in Graph 3.

Graph 4 links the rental rates of comparables, benchmarks, and the evidence submitted by the Landlord and is shown as an annual amount in a 949 square metre equivalent store.

If one applies the average occupancy costs and suggested FMRC benchmark rate to the sales the subject store achieves, the suggested gross rents linked back to the subject must be \$81,800 or equivalent, based on the evidence of comparables from country stores (with high freight charges) or 2.3% of turnover, and 3.2% of turnover if one uses FMRC as a reference point for supermarket businesses.

Graph 5 links the rental rate equivalent to the occupancy cost as a percentage of turnover that it would produce, based on the subject store's current annual sales. These figures appear above each bar graph as a percentage of turnover and on a \$/M2 basis.

The SRV must then consider the consequences of a second major supermarket in the catchment; this will be a known event which willing informed parties would be aware of if they were about to enter into a new lease. The SRV cannot ignore it and must deal with it.

Adjustment needs to be made for the new Woolworths store in the same catchment. Industry experience suggests that when a new entrant comes into a given catchment sales can fall by 20%. Does the SRV foresee that they will recover? Is there population growth to support a recovery? Could the tenancy mix be improved on in the centre over the period ahead?

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This case study is useful in that it serves to illustrate a store in a centre trading at very low levels. However, one is reasonably able to “stress test” the competency of the operator and ascertains that he is a “reasonable” operator. The rent that follows must be the “reasonable” rent, albeit at a significantly reduced amount.

What if this was a very high performing centre and a high performing supermarket, in a catchment that is protected geographically and this would endure for the term of the lease? Would a determining valuer not do a Landlord a significant disservice if he failed to consider a high performing site and centre?

This works both ways, up and down and that is why the task of a competent SRV is extremely challenging. Conversely, in high and low socio-economic areas, businesses trading at similar levels might achieve higher and lower margins. Why should a landlord be deprived of the benefit of being paid a higher rent if that is the case?

The Australian Capital Territory tenancy legislation has clear and unambiguous lease renewal system which I understand works reasonably well. There is no reason why the same mechanism can be used by businesses entering into new leases for vacant space.

At a micro level, if clear end of lease dispute resolutions were enacted across the country<sup>xxi</sup>, there would be: less potential for asset “bubbles”; better lease negotiations and more informed outcomes; fewer “stand-over” tactics and gazumping<sup>xxii</sup> <sup>xxiii</sup> at lease end; a better chance for asset valuers to value on market rent (not passing rent); less chance for major property corrections in this investment sector; more protection for shareholder interests; a more efficient allocation of capital to each relevant sector of the economy; and it would allow the market to better operate as a “market” per se.

Ultimately, the consequence of this lack of transparency is that the dysfunctional operation of the A-REIT sector has cost stakeholders a fortune<sup>xxiv</sup>. This behaviour has permeated down into smaller owners and managers as acceptable practice.

Many A-REIT security holders were forced sellers who had had very long relationships with the industry class. Many A-REITs are issuing bonds (to replace debt) or are seeking more capital from their investors.

A reasonably strong economic recovery appears to be on the way in Australia (pending a major correction in international trade with significant currency moves in recent times which could mean a paradigm shift in international trade). The underlying operation of the property industry, however, is deeply flawed due to its own behaviour.

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There is a "culture" of de facto "rent control" and price control, even by legislators, regulators, and institutional owners. This culture breaches State and Federal Trade Practices Legislation. It defies logic and a Free Enterprise economy.

What the Australian authorities completely and utterly fail to understand and comprehend is the other side of the equation.

1. Had there not been a misallocation of capital, the asset bubble in the A-REIT sector would not have built up so high and crashed so dramatically.
2. There is ongoing wholesale destruction of family and small business capital; in the end the taxpayer is funding the retirement of tens of thousands of failed business owners and even failed property investors and shareholders who became victims of margin calls.
3. The potential of many entrepreneurial ideas are being damaged and destroyed in the process.
4. Both the tangible and intangible asset values of many businesses and property investments are being or have been damaged or destroyed as a consequence of the leasing policies, dysfunctional development and financing policies.
5. Taxpayers have funded elaborate plans to maintain the status quo via "rent control" in order to keep the consumer spending, and debt has shifted from household to government.
6. The wheels are in motion for further and subsequent declines in this asset class until governments and markets make appropriate decisions.

To maintain the status quo the shopping centre industry seeks to: profit from the extension of major regional centres they manage; extend shopping centres hours (higher variable costs) i.e. it adds to variable costs of doing business particularly if no additional trade is forthcoming; and profit from unnecessary changes to fitouts when the landlord profits from all these works in setting up and closing down the shops and returning them back to "bare shells". At the same time the consumers are fast shifting their interest to cheaper shopping, i.e. on-line, or taking advantage of the strong Australian dollar and shopping overseas.

The GEM methodology of calculating current market rent, as suggested above, is a significant refinement of existing methods. The GEM "valuation" system is a disciplined set of activities and procedures, to professional practitioners and industry stakeholders to use to assist them to arrive at the "current market rent" more accurately. It links evidence and a body of research directly back to each individual lease being valued. It removes a lot of the guesswork, it improves accuracy and it will force practitioners to earn their fees and be more accountable.

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More accurate rental valuations mean:

1. Better allocation of finance to the property sector i.e. this has environmental considerations;
2. Better and more certain returns for investors and prospective investors;
3. Better fee income for skilled professionals;
4. More respect from the community

In the end the customer/clients are the beneficiaries and indirectly the economy and wider community.

## FOOTNOTES

<sup>i</sup> See "Settling rental (and other retail lease) disputes by Expert Determination" by Don E Gilbert © June 2006 at [www.leaseconsultant.com.au](http://www.leaseconsultant.com.au)

<sup>ii</sup> Occupancy cost equates to gross rent (base rent plus outgoings) as a percentage of turnover. In effect it links the rent to the performance level of the business in question.

<sup>iiii</sup> Back to basics: an Australian REIT case study of the Shopping Centre Restructuring Professionalism – Preparations for the Future, 24<sup>th</sup> Pan Pacific Congress, Seoul, Korea, 22<sup>nd</sup> to 25<sup>th</sup> September 2008

<sup>iv</sup> Secret or confidential "incentives" can mislead the market confusing shareholders, financiers, landlords, tenants, etc.

<sup>v</sup> The basic comparison criteria for categories such as offices

<sup>vi</sup> IAMA's Expert Determination Course – "The Expert Determination Process" by Robert Hunt – Barrister-at-law - states on pg 3 "..... Expert is only constrained by the terms of the agreement between the parties ....." and on pg 5 "..... should not determine matters outside the terms of the Agreement....."

<sup>vii</sup> The Law relating to Expert Determination by Robert Hunt "If the Experts Determination is in accordance with the Expert Determination agreement, then the Court cannot properly intervene."

<sup>viii</sup> API Information Paper "Rental Determinations" – Alan Hyam OAM, Barrister-At-Law and Life Fellow of the API, in March 2000 refers to Handbook of Rent Review by Bernstein and Renolds which states "it is the expert's duty to satisfy himself as to the facts of the relevant evidence" and with regard to the legal responsibility of the expert valuer "he is liable in negligence to both parties as he has a professional duty to both". McHugh JA in *Legal & General Life of Australia Ltd v A Hudson Pty Ltd (1985) 1 NSWLR 314* states "By referring the decision to a valuer, the parties agree to accept his honest and impartial decision as to the amount of the valuation. They rely on his skill and judgment and agree to be bound by his decision".

<sup>ix</sup> A category of valuers in some states in Australia that are able to do rental determinations in the state

<sup>x</sup> Losses and damages can be calculated and apportioned if parties fail to apply principles that "separate" the landlords interests from the tenants "interests" by way of disproportionate rent allocation

<sup>xi</sup> The valuation of Intangible Assets (AASB 138 or IAS 38) of which a lease or leases are an example and are to be including in balance sheets

<sup>xii</sup> See Alan Hyam who points out in "The Law Affecting Rent Review Determinations", "before embarking upon the task of assessing the rental value of premises for the purpose of rent reviews, [the valuer] must peruse the lease document ...." and "Such perusal should not be restricted to the rent review clause, but should extend to the whole lease, and associated documents, as provisions therein may have a bearing on the valuation task".

<sup>xiii</sup> S 19 RLA NSW "The current market rent is the rent that **would reasonably be expected to be paid** for the shop, as between a willing lessor and a willing lessee in an arm's length transaction (where

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the parties are each acting knowledgeably, prudently and without compulsion), determined on an effective rent basis, having regard to the following matters:

(i) the provisions of the lease,

(ii) the rent that would reasonably be expected to be paid for the shop if it were unoccupied and offered for renting for the same or a substantially similar use to which the shop may be put under the lease,

(iii) the gross rent, less the lessor's outgoings payable by the lessee,

(iv) rent concessions and other benefits that are frequently or generally offered to prospective lessees of unoccupied retail shops."

<sup>xiv</sup> 29 RSLA Queensland (and adopted into other state tenancy law), which calls on a specialist retail valuer to "determine the rent on the basis of the rent that would be **reasonably expected to be paid for the retail shop**, if it were unoccupied and offered for leasing **for the use to which the shop may be used under the lease or a substantially similar use**".

<sup>xv</sup> In Robinson Brothers (Brewers) Ltd v Houghton and Cheser-Le-Street Assessment Committee [1937] 2 KB 445 at 468 – 471, Scott LJ stated "This kind of estimating is a skilled business and it is here, especially, that the role of the skilled valuer comes in"

<sup>xvi</sup> There are over 200 retail uses in the Queensland Retail Shop Leases Act

<sup>xvii</sup> The hypothetical rent as a residual method in effect is the same as a mini business plan (forensic accounting exercise), using the Financial Statements, which after allowing for a reasonable hurdle rate of return and a proprietor wage, leaves a balance for the land i.e. rent for the landlord.

<sup>xviii</sup> See Chapter 1, Introduction to Alan Hyam's book "The Law Affecting Rent Review Determinations" relating to "The history, purpose and operation of rent review clauses" and three English cases referring to increases in property values, the value of money giving rise to market rents rising and falling – I query the relevance on the value of money in an open market when there is rigorous leasing activity. Lessors and lessees make informed decisions based on evidence in the leasing market, vacancies, business opportunity and the like. The value of money in relative terms could be a small consideration

<sup>xix</sup> Urbis Retail Averages Supermarket Centres 2007/08 – non-metropolitan National Full Range Chain traded at \$10,264 per square metre

<sup>xx</sup> Gross rent plus outgoings as a percentage of turnover

<sup>xxi</sup> ACT – Australian Capital Territory S 51 and S 52 requires that the landlord either will offer a tenant a new lease, or choose not to. In the event a new lease is offered, "must not propose that the rent to be charged initially under the renewed lease exceed the market rent for the premises". It then triggers a rent dispute resolution mechanism if negotiation fails, which then proceeds to mediation, failing which the market rent is determined by a valuer. In some states and territories some valuers called Specialist Retail Valuers are appointed to determine the market rent.

<sup>xxiii</sup> Gazumping means to "swindle". It has become customary practice for unwitting business owners, to invest in setting up a shop. The tenure granted is not sufficient to amortise the set-up costs, the rent was the rent the previous business owner failed at. Often more similar shops are introduced (loss of derogation of grant), which starts damaging for example the first coffee shop. At lease end, with the business owners capital tied to personal assets and often their bankers, the business owner must then refit the shop and expend more money. On top of it, business owners are required to "tender" against their own assets and "goodwill" against someone with no financial interest in a site i.e. fresh capital. The quality of the income streams of leases has continued to deteriorate and asset valuers have not made adequate adjustments for in accordance with IVS guidelines. Neither landlord interests, nor financiers seeking mortgage backed security from leases, have worked out how damaging this practice is.

<sup>xxiv</sup> See – IVS International Valuation White Paper, "The Valuation of Real Estate Serving As Collateral for Securitised, Instruments" – "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".

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