8 October 2007

Mr Paul Gretton
Secretary
Inquiry into the Market for Retail Tenancy Leases in Australia
Productivity Commission
PO Box 80
Belconnen ACT 2626
By email: retailtenancies.pc.gov.au

Dear Mr Gretton,

Inquiry into the Market for Retail Tenancy Leases in Australia. Further Submission by Mr Craig Kelly

I refer to submission no. 131 on the Productivity Commission website, dated September 2007, relating to the Inquiry into the Market for Retail Tenancy Leases in Australia, from Mr Craig Kelly, who operates under the name of 'Southern Sydney Retailers Association'.

We have previously addressed the issue of international rent comparisons in our submission to the Inquiry. Nevertheless we thought it would be useful to the Productivity Commission if we commissioned an independent report on this matter from Mr Michael Baker. Mr Baker, an Australian, is a former Research Director of the International Council of Shopping Centers, headquartered in New York, and is now an independent retail consultant in Australia, based in Adelaide. Mr Kelly quotes from one of Mr Baker's research papers in his (further) submission. Mr Baker has experience in shopping centre economics across a range of countries, but particularly in the United States of America and Australia.

I **attach** a copy of Mr Baker's report. Given that Mr Kelly's submission is posted on the website I would be grateful if you could also post a copy of this letter, and Mr Baker's report, on the Productivity Commission website too.

Yours sincerely,

Milton Cockburn
Executive Director

cc Mr Neil Byron, Commissioner
Mr Steve Kates, Commissioner

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Comment on the Submission by the Southern Sydney Retailers Association to the Productivity Commission Inquiry on the Market for Retail Tenancy Leases in Australia

Michael Baker
September 28, 2007

Comment on Southern Sydney Retailers Association Submission

Purpose

The Shopping Centre Council of Australia has requested me to comment on the submission of Mr. Craig Kelly of the Southern Sydney Retailers Association to the Productivity Commission Inquiry on the retail tenancy lease market. The SSRA submission was devoted primarily to a comparison of market conditions in the US and Australia. My comments were requested by the SCCA specifically because of my professional experience with, and extensive knowledge of, the retail markets in both the US and Australia. I am closely familiar with the US company financial statements and the US industry benchmark publication cited by SSRA in its submission.

General Comments

Mr. Kelly's submission contains a number of factual errors and misconceptions that have a direct bearing on the conclusions he reaches about asymmetries in the US and Australian retail leasing markets. I have corrected and/or clarified these errors and misconceptions point-by-point in the following pages.

The errors themselves are caused by misuse of statistics, selective use of statistics, and either deliberate or inadvertent confusion of concepts in a manner that misleads the reader. To the extent that the confusion is inadvertent it may reflect an unfamiliarity on the part of the author with financial statements, shopping centre economics and shopping centre jargon. Whether inadvertent or not, he makes a series of inappropriate comparisons between Australia and the US that lead directly to the wrong conclusions.

Before responding to each of Mr. Kelly's assertions in detail, it is worthwhile flagging some particularly eggregious examples up front. These are:

- Misuse of statistics: Throughout his submission the author repeatedly compares US rent/sales ratios with Australian occupancy cost/sales ratios, evidently in an attempt to make Australian occupancy costs appear heinously outsized. Those with even a passing familiarity with shopping centre economics in either Australia or the US are aware that rents are only a subset of occupancy costs, which also include common area maintenance (CAM) charges, utilities, taxes and other charges. Thus, comparing US rents with Australian occupancy costs is highly inappropriate and misleading. It is a little like comparing the price of a facial with an all-day spa treatment.
- Misuse of statistics: In the final column of the comparison table that concludes the submission, the percentages entered for Australia appear to be occupancy cost/sales percentages even though the column is headed "rent/sales percentage." The equivalent column for the US does contain rent/sales percentages. The comparison is therefore invalid and misleading for reasons stated in the previous paragraph.
- Selective use of statistics: The author repeatedly compares the two countries using statistics that are not true industry averages. For the US he variously uses the portfolios of Simon Property Group and Westfield as proxies for the whole US industry, and for Australia he uses Westfield. This ignores the huge diversity in the quality of properties and property portfolios, especially in the US where there are approximately 1,200 regional centres and 50,000 shopping centres.
- Unfamiliarity with shopping centre economics: The author is either confused about what makes shopping centres work in an economic sense or chooses to ignore it because it doesn't support his case. For example, he suggests that relatively higher sales productivity of US department stores vis-à-vis those in Australia should cause US rents to be higher than those in

Australia. He doesn't seem to understand that department stores in the US generally don't pay rent and that the sales performance of department stores has no bearing on rent charged to specialty stores either. To get at the true drivers of shopping centre rental levels, the focus should be on specialty store sales productivity, shopping centre occupancy and market competition. However, he cites no relevant data on the first or second of these and appears to minimise the importance of the competition issue.

Comment on Southern Sydney Retailers Association Submission

Specific Comments

Supply of Retail Space

On page 1 of his submission, Mr. Kelly attributes the relatively greater supply of US retail space per capita on (1) higher US disposable income, and (2) the colder US climate that causes people to spend more on clothing. These factors have a degree of validity but he misses the most important part of the story as it relates to rental levels.

The supply of both shopping centre and retail space in the US are indeed significantly higher in the US than in Australia. The US data is somewhat unreliable because of the size of the country and the vast number of retail establishments, which makes the amount of floorspace impossible to track on a comprehensive basis. However, as best as industry experts can estimate, there is more than twice the amount of shopping centre space and between 50-75% more total retail space on a per capita basis in the US than in Australia.

Apart from relatively higher disposable income per capita, the greater amount of floorspace in the US compared with Australia is due to a number of important factors that are material to the discussion of occupancy cost differentials. These factors include:

- A history of relatively lax zoning restrictions in the US vis-à-vis Australia, which allows more retail projects of a marginally competitive nature to get permissions and get built in the US.
- The aggressive expansion of big box retail chains in the US. These retail chains are usually publicly-owned (i.e. listed and traded) and the public markets demand consistent growth through new store openings.
- Many large US retail chains (e.g. Wal-Mart) have traditionally operated on the basis of strategic market share gain rather than short-term profit maximisation. This means that in order to draw away customers from their competitors they are prepared to cannibalise sales from their own stores by opening new ones in the near vicinity of existing ones. Land use policies in Australia would generally not permit this to happen.
- There is a tradition of more speculative retail development in the US. Shopping centre developers have historically been able to obtain financing for projects with few pre-signed tenants.
- The ownership structure of retail properties in the US is very fragmented. There are many small entrepreneurial companies pushing for growth by developing new centres.
- Store design, amenity and service are much more critical to the marketing of an American retail concept than in Australia. Thus, US stores are on average vastly more spacious than their Australian counterparts in order to accommodate wider aisles, good sight-lines and more cutting-edge display techniques.[1] Merchandise display density is lower (i.e. there is less clutter) so that the roving eye can more easily focus on the product on display. The result is that turnover per unit of floorspace tends to be lower for comparable store types in the US than in Australia, which also flows through to rent per unit of floorspace. US retailers often compensate for lower sales per sq.m by targeting higher margins and profitability. This is particularly true of regional centre-based chains.

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[1] For example, the average floorspace for an Australian regional centre apparel store is 124 sq.m, according to Urbis. In the US there is no national benchmark as such but a good example of an average regional centre apparel boutique would be Gap Inc., which has almost 1,300 stores under the Gap, GapKids, babyGap and GapBody nameplates. The average size of these stores is 880 sq.m, or more than seven times the size of the average Australian boutique.

Comment on Southern Sydney Retailers Association Submission

The much higher retail space per capita in the US and the factors that cause it have resulted in some stark contrasts between the US and Australian retail markets that are relevant to the issue of rental rates. These include:

1. More competition among retailers and shopping centres for the consumer dollar in the US, which lowers the overall productivity of retail space in the US relative to Australia. The US regional centre segment has been particularly hard-hit by competition in recent years from a plethora of emergent formats that don't even exist in Australia, including power centres, warehouse clubs, supercentres and lifestyle centres. As a result, many regional centres have closed and are closing. The current number of about 1,200 regionals compares with more than 2,000 as recently as a decade ago. Australian regional centres are much more stable and dominant in the overall national retail landscape. From the retailer's perspective, an Australian regional centre is a much safer bet than an American one. The Darwinian survival struggle in the US is part of the reason for generally lower rates of occupancy, lower sales productivity and lower occupancy costs at US regional centres vis-à-vis Australia.

2. Relatively greater heterogeneity in the quality of US retail properties according to such factors as location, development and management skills, frequency of renovation, property maintenance and tenant mix. Thus, while some shopping centres are in prime locations and offer the best nationally-recognised tenants and amenities, others are struggling, under-invested, boast lesser quality tenants and have high vacancy rates. Moreover, due to the extreme mobility of American society, demographic change within the trade area of any given shopping centre can be rapid and lethal. Since retailers are also mobile and able to move quickly to an alternative location, a strong shopping centre today can quickly find itself terminally challenged. In contrast, Australian centres are more homogeneous and stable with respect to their management, tenant mix, and overall market position. Note that the principal Australian shopping centre anchor segments—department stores, discount department stores and supermarkets—are relatively stable oligopolies in Australia. In the US they are highly fragmented and consolidation-prone. From a rent or occupancy cost standpoint the greater heterogeneity of retail property quality in the US means that individual portfolios (e.g. Simon and Westfield) are not necessarily representative and do not provide good industry benchmarks.

3. While an occupancy rate of around 90% at an Australian regional shopping centre would be well below average and unacceptable to the owner, it is quite common in the US and would not necessarily indicate a weak centre. However, in as much as lower occupancy rates are a more permanent structural feature of the US shopping centre market, rents tend to be lower than in Australia. This is a basic matter of economic supply and demand where the market clears at a lower equilibrium price (in this case rent).

Department Store Sales

Mr. Kelly argues on page 2 of his submission that the relatively higher spending power of Americans and the superior performance of US department stores compared with Australian department stores should lead us to expect higher shopping centre rents across the board in the US than in Australia. He appears not to understand that department stores don't pay rent in America and have no direct bearing on overall shopping centre rents.[2]

[2] A strong department store anchor can draw more traffic to a centre and benefit the specialty stores. In this sense, department stores and other types of anchors are an important part of the regional centre business model. However,

Rather than department store productivity, specialty store productivity is the primary determinant of specialty store rent and hence the economic viability of a shopping centre. Australian regional centre specialty retailers have a decided advantage over their US counterparts as noted above—planning constraints that have limited competition among existing retail players combined with the inherent stability of the retail anchor oligopolies have helped make existing regional centres highly productive retail locations with exceptional volumes of foot traffic. In the US, regional centres with the market dominance of most Australian regionals would be referred to as "fortress" centres.

Specialty Store Sales

For reasons already noted, Australian regional centre specialty stores have much higher turnover per sq.m than in the US. Average sales per sq.m at US mall specialty stores were US $4,330 in 2006.[3] This compares with approximately US $7,575 for Australian regional centre specialty stores at current exchange rates.[4] In other words, Australian specialties enjoy a premium of 75% in sales per sq.m over their US counterparts. If rents per sq.m were to be the same in Australia and the US under these circumstances it would reflect gross negligence on the part of Australian shopping centre owners to their shareholders.

On page 3 of his submission, Mr. Kelly cites Westfield data showing a 134% difference in rent per sq.m between its Australian and US portfolios. Factors that account for this are as follows:

- Superior average turnover per sq.m enjoyed by Australian retailers, as noted above
- Differences in the quality and market dominance of Westfield's US and Australian centres. This is reflected in variable occupancy cost ratios at Westfield's US centres, ranging from as little as 8% to more than 21% according to Westfield's annual report. In Australia, Westfield's centres tend to be dominant in each market and have consistently high rates of occupancy.
- Westfield's US centres are usually up against much stronger competition from a variety of non-regional centre formats that don't exist in Australia, such as lifestyle centres, power centres, supercentres and warehouse clubs.

Also on page 3 Mr. Kelly ridicules the empirical fact that larger stores command less rent per unit of floorspace. This has already been refuted above.

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there is no direct relationship between department store sales and specialty store sales or rents. US department stores do not generally even report their sales to shopping centre owners.
Note also that Mr. Kelly's assertion regarding the superior performance of US department stores is backed by 2003 data that has been superceded by more recent information—according to my calculations based on the most recent data and exchange rates, Australian department stores are now doing as well as or better than their US counterparts with respect to sales productivity.

[3] International Council of Shopping Centers (ICSC) provide non-anchor sales productivity data for US regional centres on a monthly basis. See www.icsc.org.

[4] Urbis 2007 Retail Averages (October 2007)

Comment on Southern Sydney Retailers Association Submission

Simon Property Group Portfolio

On page 4 of his submission Mr. Kelly quotes from Simon Property Group's 2006 annual report that the Simon portfolio's rent/sales ratio is 7.4%. He compares this to a supposed Australian rent/sales ratio of 18-20%. There are three very significant problems with this comparison.

1. Mr. Kelly is either intentionally or inadvertently comparing the rent/sales ratio for a US portfolio with a supposed occupancy cost/sales ratio for Australia. The 7.4% rent/sales ratio doesn't include common area maintenance (CAM), utilities, taxes and other charges levied by Simon on its tenants, which are collectively referred to as "expense recoveries." Adding in these charges would bring the occupancy cost/sales ratio up to an estimated 12-14%.[5]

2. The 18-20% figure is not the industry average for Australian regional centre specialty stores as Mr. Kelly tries to infer. The most recent published data indicates that the Australian industry average is 16.3% in 2006-7.[6]

3. The Simon portfolio is diverse and strong but by no means the best quality mall portfolio in the US. Given the dominant position of Australian regional centres in their own market compared with that of the American regional centres, it is probably fairer to compare the Australian regional centre industry with top-flight US regional centre portfolios that tend to exhibit higher rental values. For example, the occupancy cost/sales ratio for the portfolio of Taubman Centers, a high quality US mall REIT, has varied from 14-16% over the past few years. (Note that occupancy cost/sales ratios will vary from quarter to quarter and year to year for a number of reasons. Intra-year variation is often due to the seasonality of sales, whereby sales growth surges around Christmas-time but lags in the following quarter. Inter-year variation can be caused by the fact that leases are renewed according to a fixed schedule independent of what is happening to sales.)

Factory Outlet Centres

On page 4, Mr. Kelly repeats the mistakes outline above with regard to Simon's factory outlet portfolio. Factory outlet centre rent/sales ratios can not be compared with occupancy cost/sales ratios for Australian regional centres. This is not just because rent/sales and occupancy/sales are distinctly different metrics as explained earlier. It is also because factory outlet centres and regional centres are different kinds of retail properties that operate according to different business models.

European Shopping Centres

On page 6, the same mistake is repeated again with regard to Simon's European portfolio. Rent/sales ratios can not be compared with occupancy cost/sales ratios. Consequently, all of Mr. Kelly's claims based on information from Simon's annual report can be regarded as false and misleading.

On page 7, Mr. Kelly goes on to compare occupancy costs at Westfield's Australian centres with those of the Rodamco portfolio in Europe. It is unclear what Rodamco includes in occupancy costs and therefore

[5] US REITs are not required to report occupancy costs in their financial statements, and most, including Simon, do not.
[6] Urbis, 2007 Retail Averages (October 2007)

unclear whether it is an "apples to apples" comparison. It is also not clear that the Rodamco properties are comparable to Westfield's in terms of configuration, tenant mix, and so on. Different kinds of centres have different business models and rental structures.

Office vs. Retail Comparison

The comparison on page 6 between office and retail rents is irrelevant. Retail and office markets have entirely different supply/demand characteristics within and across countries.

Comparison Table: Australia vs. US Regional Centre Rents

The table purporting to compare rents between Australia and the US is particularly misleading and needs to be clarified.

- Figures cited for the US are rent/sales ratios while those for Australia are represented as rent/sales ratios when in fact they are occupancy cost/sales ratios. This substitution of one concept for another has already been addressed in detailed above.

- The US data is based on a tiny sample that even the authors are at pains to point out is not statistically reliable. Fewer than 20 centres are represented for some tenant categories out of 1,200 regional centres nationally.

- Again Mr. Kelly is comparing a purported industry benchmark from one country with a single portfolio from another.

In conclusion, Mr. Kelly's submission presents a set of statistics that misrepresents both the US and Australian markets and attempts to portray a gross asymmetry in the behaviour of US and Australian shopping centre owner/developers. The data, imperfect as they are in the case of the US market for reasons explained above, show that differences in occupancy costs/sales ratios between the US and Australia are not wide and are easily explained by differences in the structure of the retail markets themselves.