FACTORING THE INTERNET INTO LEASES

LANE4 PROPERTY GROUP

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THE POPULARITY OF ONLINE shopping and the prevalence of "show-rooming" are changing the way some merchants use store space and forcing shopping center owners to redefine the term "tenant-initiated sale" and to recalculate percentage-rent formulas. "More and more, it's apparent that retailers are leveraging their stores to drive on-line transactions," said Ken Lamy, president of the New Orleans-based Lamy Group, a financial management consulting firm. Lamy has been working with landlords to adapt lease language to define gross sales as any purchases that from a store, even if shoppers are not exiting with merchandise in hand. "That's the nexus for this: if a store 'touched' the sale."

For instance, even when a customer receives merchandise home-delivered special because the desired size or color was unavailable during the initial store visit, that transaction should be counted among the store's gross sales and be subject to percentage-rent calculations, Lamy says. "It's not even a gray area," he said. "It's clear and has to be reported, because the store was involved in the fulfillment." Catalog and Internet sales initiated in the store, too, are areas in which the reporting of gross sales often comes into question, Lamy says. "This has been measured to be as high as 10 percent of store sales not originally reported to the landlord."

Lamy talked to RECon attendees who urged him to help educate the industry on the need for more-accurate accounting of Internet sales, returns, refunds, and related activities at stores. In a compliance examination for a client, Lamy identified one tenant that failed to report some $250,000 in store-related Internet sales per year, or an annual average of 24 percent of previously reported sales over the time span. The client recovered some $30,000 in percentage rent.

The issue has international ramifications too, and marks the latest stage in the evolution of retailer-landlord partnerships, says Gerard Groener, CEO of Holland-based Corio, one of the largest retail owners and managers in Europe. Given the showrooming trend where smaller-prototype stores carry limited lines but offer in-store online purchasing, "some of the rent may have to come from store PR budgets," he said. Corio, which selects retailers based in part on whether they have a sensible online strategy, is seeing more outlets open up for what had been predominantly online stores, says Groener.

The times call for revised rent formulas, according to Kelly Millin, president of the Vancouver, British Columbia-based Real Solution Marketing Group. "There has to be a new per-square-foot sales reporting model developed to account for online sales attributed to a retailer in a shopping center," said Millin. "I can report firsthand that lost sales to online purchases is a serious reality for our centers that's moving through like a tsunami." She cites ComScore data indicating that U.S. online sales grew by 15 percent last November and December, from the comparable year-before period, versus a 4 percent increase in shopping centers; the disparity represents a costly problem for the industry.

At this point in the industry's recovery, however, a phrase like "percentage lease Internet sales" can easily raise the ire of tenants, cautions Debbie Naves, proprietor of Naves Temporary Property Management Services, Raleigh-Durham, N.C. Moreover, retailers could circumvent efforts to group such sales in with conventional ones, by means of strategies like setting up a separate entity. "It's difficult enough to cut deals and accomplish annual reconciliations with large tenants who market on the Internet," said Naves.

Jeffery Edelman, director of retail and consumer products advisory services at Minnesota-based consultant firm McGladrey, says most landlords lack the latitude to renegotiate leases to account for store-initiated online sales, particularly with vacancy rates at many centers remaining high. Fulfillment of out-of-stock items should be subject to store-sales tabulations, but that is insignificant relative to the sales volume of items ordered online for pickup at a store, he says. "Many stores operate as a distribution center, allowing the consumer to pick up," he said. Best Buy, for one, estimates that some 40 percent of its online purchases are handled that way, Edelman points out. Arguably, those items could be grouped into that particular store's aggregate sales, but Best Buy is likely to resist, given that high percentage volume, together with its current struggles. Internet orders delivered directly to a shopper's home, he said, are "a different story and, I believe, a stretch for any landlord to try and claim those revenues."

Thus far there has been no consequential litigation on the accounting controversy. One observer says retailers are unwilling to see the law tested in court, because a landmark decision could set an undesirable precedent. Regardless, no one should expect the old leasing model to disappear overnight, says Groener. "In many cases it will be difficult to trace where the actual purchase or decision to purchase was made, and therefore difficult to link it to a specific store," Groener said.

The issue has been on the minds of landlords and retailers since the explosion of online sales began, though there has been no widespread push to change the definition of gross sales – yet. "The last several years have taught us that these types of issues and their financial implications have to be worked out in a win-win quadrant and must be affordable, sustainable and transparent for both parties," Lamy said. There has to be equilibrium so both sides can achieve their financial goals and share information, he says.

The issue is growing more significant, and the industry needs to pay closer attention, says Owen Buckley, president of Kansas City, Mo.-based Lane4 property group. Stores are becoming like bill-boards in some respects, says Buckley, who offers representation services to both landlords and tenants. "You hope [they] will influence the marketplace and make people react to your company and full line of products with them." A growing number of retailers have been forced to counter the Amazon.com effect with their own in-store online programs. The challenge will be to find a flexible sales-accounting formula that retains the retailer's competitive edge yet still compensates the landlord for driving the foot traffic, Buckley says.

Large retailers are also at work defining what constitutes a store-initiated sale. Walmart, whose online sales are just 1 percent of annual revenue, according to market researcher Kantar Retail, is trying to expand that by rewarding employees who refer shoppers to Walmart.com whenever any merchandise is unavailable at the store. The retailer credits the purchases to the ledger of the store nearest the consumer. About half of the shoppers who buy on Walmart.com pick up the purchases at the store, according to the company.

Creating a sustainable earning model has become a far more complex and costly undertaking these days because of the necessity of accommodating entertainment, events, residential components, gourmet food courts and a wide variety of service businesses at shopping centers, Groener says. "The principles of innovation are far from what property investors are used to," he said. "The time developers could simply present a line of shops with a roof and make a profit is gone." Eventually, percentage rents may have to rise, as the relationship between retailer and landlord shifts from supplier-client model a form of broader partnership, he says.

"The store space is rented to generate sales for the retailer in partnership with the landlord," Lamy said. "The store pays base minimum and percentage rent to use that square footage, so anything that happens in that space enters into the calculation."