Online Conundrum

Landlords and tenants grapple with how to calculate rents based on omnichannel sales

By: Joel Groover

What would happen if a basic question in the shopping center business — exactly how much money a store makes — became impossible to answer? Because of the rapid growth of omnichannel retailing, landlords need to start thinking about this disruptive scenario, some say. To understand why, consider the way the industry operated before the arrival of the Internet: While heavyweight chains sometimes negotiated do-not-report clauses, others dutifully divulged their sales according to the dictates of the lease. These numbers were straightforward and auditable, because customers had only one way to buy things: They stood in line at the cash register and paid for their items in person. Landlords then used this sales data to calculate percentage rents, negotiate higher rents during lease renewals and pitch the productivity of their properties to prospective tenants and investors.

But today's omnichannel realities threaten to overturn this decades-old paradigm, with potentially wide-ranging implications for the industry, experts say. "The entire purpose of the store is changing, and that means how we measure the productivity of a space — and ultimately, the productivity of real estate — needs to be very different as well," said Melina Cordero, head of Americas retail research for CBRE. "It used to be simple — sales per square foot — but now it is much more complicated."

In this omnichannel era, more retailers are using brick-and-mortar stores to build their brands and drive online sales, often setting aside square footage to use for fast fulfillment of ecommerce orders. Amid these changes, landlords are struggling to receive credit for the pivotal role their real estate plays in catalyzing retail chains' omnichannel efforts. Imagine a grocer that has scored a hit with its click-and-collect program. Cars could fill the pickup lane in the landlord's parking lot day and night, but would the grocer report these sales to the landlord? After all, the transactions were done on shopper phones, laptops and tablets, and not through the POS system inside the store.

"When a retailer reports sales, what is it reporting?" observed Jeff Green, owner of an eponymous retail consulting firm based in Phoenix. "Is it just brick-and-mortar sales? What if the item is ordered over the Internet at that location? It is becoming very confusing for landlords to assess exactly what sales are going through these brick-and-mortar stores."

Whenever shoppers use stores as a place to see, touch and feel merchandise before buying it online — the phenomenon known as "showrooming" — the landlord's real estate plays a key role in the process. Indeed, the business models of such retail tenants as Pirch, Tesla or Warby Parker are even geared toward leveraging showroom-like stores to drive Internet purchases. "Tesla doesn't sell anything in its stores," Cordero said. "It is zero sales per square foot, because the transactions are done virtually, and no one drives away from the store in a new Tesla. So how do you really measure Tesla's store performance?"

The trend that involves using stores for so-called "last mile" fulfillment of ecommerce orders similarly creates pressing questions for landlords. As Amazon.com forges ahead with same-day delivery in major markets, more chains are seeking to compete by having their stores double as fulfillment centers. From the landlord's perspective, real estate is an essential part of this process, notes Bradley W. Snyder, executive managing director of Tiger Capital Group, an advisory, asset-valuation and disposition firm. "But it's complicated," he said. "The line is blurring between what used to be fulfillment out of a warehouse and, now, how retailers are fulfilling orders out of their stores. Are those sales relevant for percentage rent or not?"

As omnichannel retailing accelerates, the perceived productivity of properties and stores could suffer if the industry fails to account for the new ways in which retailers leverage brick-and-mortar real estate, Cordero says. "Increasingly, retailers are shifting online, and so even though a brand's overall sales may stay the same or go up, its sales [at brick-and-mortar stores] may go down," she said. "Does that mean the store is not productive? Not necessarily. The store might be what seals the deal. It's just that the transaction happened elsewhere."

Challenges arising from these new dynamics are creeping into conversations — and, in some cases, into lease negotiations — among retail executives and landlords across the country, says Herky Pollock, executive vice president and Northeast director for CBRE's retailer services group. "We are seeing this topic rearing its head far more often today than it was a year or three years ago," Pollock said. "Just how to deal with it yet has not been fully resolved."

The effects of omnichannel retailing on rent are of particular concern to landlords. At some shopping centers, once a store crosses a certain threshold of productivity, the chain will pay a percentage of its total sales, over and above its base rent. These percentage-rent agreements enable owners to share in the upside of thriving chains at their properties. In other arrangements, percentage rent functions as a form of rent relief: The landlord forgoes base rent and collects only percentage rent as a way to prop up tenants at risk of going dark. And in yet another scenario, percentage rent kicks in as a result of the triggering of a co-tenancy provision. “Let’s say the landlord loses an anchor or key tenant that is tied to another retailer’s co-tenancy,” said Jason Baker, co-founder of Houston-based brokerage firm Baker Katz, a member of X Team International. “Oftentimes that remaining tenant will have the option of either terminating its lease or just rolling to a percentage-rent-only scenario.”

In a variety of situations, then, landlords could find themselves collecting percentage rent based only on register receipts while missing out on credit for online sales that hinged on their real estate. And if over time those rising online sales actually erode tenants’ reported gross sales numbers, landlords will start to see their rental incomes drop in tandem. “When you have tenants that are paying percentage rent, either in addition to the fixed rent or in lieu of it, this has a lot of impact on the center’s net operating income,” said Frederick J. Meno, CRX, CSM, president and CEO of asset services for The Woodmont Co. “There is no uniform standard for how retail sales are supposed to be accounted for when you bring in the Internet component. Today a lot of Internet sales are simply not being reported.”

Omnichannel retailing can complicate life for landlords in other ways too. When chains such as Nordstrom or Dick’s Sporting Goods report to Wall Street, they may tout the strength of their ecommerce programs by presenting their online numbers right alongside their brick-and-mortar sales. Publicly traded development companies, by contrast, face the prospect of giving Wall Street only half the picture, says Green. “The retailers can talk about their productivity in the aggregate: Brick-and-mortar plus online equals total sales,” he said. “But how do landlords describe it? They don’t have those Internet sales broken down for their properties or portfolios. They only have brick-and-mortar sales.” Thanks to the shortcomings of these less-impressive performance stats, he says, landlords could have a harder time wooing new tenants to their shopping centers. “Developers will commonly say, ‘Such-and-such retailer at my center is doing x amount per square foot,’ ” observed Green. “But as the Internet goes up, those sales-per-square-foot numbers will likely go down.”

Eventually, these shifts could undermine the usefulness of comparable data, such as when landlords or retailers present the year’s total sales alongside those of previous periods. “It is going to make it hard, going forward, for a completely accurate, apples-to-apples comparison of retailer or center performance,” Meno said. “If you look at what a center’s sales-per-square-foot figure is today versus five years from now, it is going to be tough, because Internet sales are probably going to be higher.” A shopping center could even end up slipping by one letter grade — say, from class ‘B’ down to ‘C’ — thanks to the statistical muddle created by omnichannel retailing. “How a center’s sales are performing affects how it is classified in terms of ‘A,’ ‘B,’ ‘C’ or ‘D,’ ” Meno said, “and those classifications have great impact on value, from an investor standpoint.”

In lease negotiations, some landlords are now pushing retailers to report any sales that involve brick-and-mortar stores, regardless of whether customers paid at the register or online. “My leases clearly do provide that no matter where that customer makes a purchase, if it originated in my shopping center, it counts,” said Sandy Sigal, CEO and president of Woodland Hills, Calif.–

based NewMark Merrill Cos., which owns and/or manages 70 retail properties throughout California, Colorado and Illinois. “The technology to track those sales is what is behind the eight ball.”

Click-and-collect is a particularly contentious issue, says real estate attorney Stan Ames, general counsel of Stokas Bieri Real Estate, a member of X Team International. “Regarding the language in the percentage-rent clause and the definition of gross sales, there has been a lot of dialogue back and forth,” he said. “Landlords are making the argument that if inventory is shipped to the store for pickup, they want to capture that as a sale in the center. That’s the language I do see the landlords trying to push into the leases.”

As Meno sees it, in all new or renewed leases, landlords should protect the value of their shopping centers by requiring tenants to report all sales, including Internet-related sales, whenever the physical store and the purchaser “touch” each other. “That means whenever the purchaser and the store physically connect — either at the time the order is placed at the store, the purchaser picks up the order at the store, or both,” Meno said. “In those instances, the lease language needs to place the onus on the tenant to maintain proper books and records to account for these different types of transactions. You want those related sales included in the gross sales figure that tenants report to the landlord.”

With click-and-collect, landlords should be able to require sales reporting without facing too many technical obstacles, Meno says, as these location-based transactions directly affect store inventories. “Any merchandise picked up in the store is easily trackable,” he said. “You can audit the store inventory and see how that is tying to the sales transactions.” Showrooming, though, amounts to a black box for retailers and landlords alike. “If someone is standing there in the store and orders something off the website on their phone, I don’t know how you figure out what those sales will be,” Meno said.

In a scenario in which a shopper tries on some jeans at a store, likes the fit and later buys four more pairs through her laptop at home, the landlord’s real estate clearly played a role — but how will anyone know? “Where it truly is an online sale, there is really no way for the tenant to know precisely what generated the interest that drove that purchase,” said Ames. Cordero does cite one possible exception: Shoppers could opt in to apps that enable retailers to track their precise locations when they buy things online. For now, though, this is relatively rare, Cordero says.

In figuring out how to respond to these changes, landlords are exploring a variety of options. One approach is to deemphasize percentage rent, a trend that may already be accelerating, at least in part, as a response to the complexities of omnichannel retail, says Daniel (DJ) Busch, managing director of retail for Green Street Advisors. “As leases expire, some landlords are moving to a fixed-rent system,” he said. “Maybe that means, if sales are tremendous, they are not participating as much on the upside. But as the lines between ecommerce and brick-and-mortar have continued to blur, it affords a level of protection for these landlords. It is also about stability of cash flows.” Nonetheless, Busch points out, landlords at high-performing —

and — class-A malls may still charge percentage rent, particularly when dealing with new tenants such as ecommerce retailers launching brick-and-mortar stores.

As landlords negotiate these new base rents, they need to make strong arguments for all the ways their shopping centers bolster tenants' omnichannel efforts, Pollock says. "As we go forward, landlords will get more sophisticated and will make the case that there is true benefit to having brick-and-mortar," he said. "That may come in the form of a higher fixed rent and saying, 'Look, rather than going through all of your online sales, we're just going to increase your rent by 20 percent, because we know you're driving that much business or more simply by being at this center.'"

In fact, some chains are quite open to this approach, so much so that they are even encouraging landlords to ditch percentage rent in favor of fixed payouts, according to Ames. "Some of the more sophisticated retailers out there are trying to push landlords toward a concept of, 'Look, determine what your rents ought to be based on how you value your real estate, and get rid of this concept of percentage rent,'" Ames said. "They don't want to argue over percentage rent anymore or have it be a trip hazard in their leases. They recognize that fixed rents are easier for everybody to administer across the board."

This would amount to a huge shift for retail properties where percentage rent arrangements are commonplace, including many outlets, lifestyle centers and regional malls. But the industry has been through such sea changes before, notes Ames. Back in the late 1980s, landlords and tenants routinely locked horns during lease negotiations over CAM charges, which varied widely from one lease to the next. Over time, though, the industry transitioned to a fixed approach. Ames recalls being skeptical that such a change was possible. "I didn't think fixed CAM would last," he said. "People were worried that if costs got out of control, landlords would stop maintaining their centers. But we now have enough years of history to see that this usually does not happen."

Others envision another seemingly implausible shift: retailers and landlords openly sharing data in ways that allow them to better gauge the value each side brings to the table. New tech tools have the potential to help landlords make a stronger case for working together, according to Cordero. "There are opportunities, especially in data sharing — whether it is traffic counts or other data that landlords and owners are collecting — that landlords could share to help retailers better measure, or improve, their performance," she said.

As they employ apps, loyalty programs and cellphone-tracking beacon and geofencing technologies, landlords are learning things their tenants would love to know, Pollock says. "Think of the data Simon has through its loyalty program, which touches countless markets and many of the top malls in the country," he said. "You could see someone like Simon saying, 'OK, you share your data, and we will share ours.'" In some cases, Pollock says, landlords could let tenants market to their customer databases, and tenants could in turn share more data about their ecommerce sales. "It then becomes a true partnership," he said.

Sitting at his office desk, Sigal can call up software that enables him to track customers at one of his shopping centers in real time, thanks to beacon technology that zeros in on shoppers' always-on cellphone signals. "Right now I am looking at a screen and it is telling me that, at this very second, I have 375 visitors at that center," he said. "I can know what the difference is compared to last Tuesday or the Tuesday average, and I can compare that to what other centers of mine are doing. I know who is coming to my shopping centers, how often they shop, how long they stay and where they go."

Ultimately, retailer rents will be based in part on the ability of landlords to answer such key questions, Sigal predicts. The two sides can then share information to ramp up the performance of shopping centers and stores. "Once that starts taking place, it will be the answer to how you monetize this," Sigal said. "It's not about shaking them down to get more money out of them, it's about helping them convert the traffic you send their way into sales. They can also help you do a very effective job of bringing more people to that center."

According to Green, such a change would amount to a new way for the industry to think about store performance. The transition will take years to play out, he speculates, and this is likely to meet with resistance from some quarters. Lease language, too, will need to change, he says. "The whole industry is going to have to get away from sales data and move toward customer data," Green said. "That is a huge shift. It goes beyond just reporting of data — it is a sea change in mindset and the way we all evaluate certain things."

But retailers and landlords have been getting used to collaboration ever since the 2008 financial crisis, which forced them to work together to survive. This makes it only natural for them to share data amid the challenges of ecommerce, Sigal says. "As everyone gets more motivated to find ways to succeed in this new world, you're going to break the old molds of landlord versus tenant," he said. "We're going to find different ways to cooperate. With a lot of tenants, that is already starting. We need to continue with that process."

CBRE, too, sees the industry headed in this direction. The firm is already conducting research on the ways landlords and retailers may work together to boost performance, according to Cordero. "As opposed to a traditional tenant-landlord relationship," she said, "the industry is evolving toward a partnership mentality."

http://www.icsc.org/sct/shoppingcenterstoday/may2017/onlineconundrum