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Workshop 5

**Measuring Omnichannel/Internet/E-commerce Gross Sales to Customers You Can't See—
Do they count? Should they count? The Sales, that is.**

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Why does Tenants' Gross Sales Reporting Matter? How Are the Data Used?

For decades, shopping center owners have lease-obligated tenants to report sales activity at the store level. Now more than ever, owners use the sales data for several key purposes. These purposes are at the very heart of an owner's investment in the shopping center asset—these data can influence asset revenue, asset net operating income (NOI) and overall asset value. Lastly, it provides the data element to assess and classify the quality of the retail real estate asset. e.g. (Class A+, A, B+, B, B-, etc.) A deeper discussion on this attribute follows.

Individual Location Sales Data as a Basis for Rents Paid to the Owner

Traditionally, the term “percentage rent” was a tenant payment obligation based on the success of the store within the shopping center. Specifically, sales more than an agreed-upon threshold (Breakpoint) were multiplied by an agreed-upon percentage, and this was the amount of the percentage rent payment to the owner from the tenant. For example, if sales during a year exceeded \$5 million, then the tenant might be obligated to pay 5% of the excess amount as percentage rent. Secondly, in a remedy situation, sales may be the basis of rents. A lease might specify that until a detrimental situation or financial distress was resolved, the tenant was entitled to pay a percentage of sales in lieu of some or all rents. Examples of a detrimental situation may include a violated exclusive, a co-tenancy failure event or a rent relief request. For example, a tenant might be entitled to pay 5% of gross sales in lieu of minimum and percentage rent—or in lieu of minimum rent, percentage rent, additional rents. A third scenario is when the tenant and ownership agree to share some risk on a short-term basis. For example, tenant may agree to postpone a termination right and remain in operation for a short period in exchange for a rent reduction to a percentage of sales. An example may be that for the postponed period of 24 months, the tenant will pay 15% of gross sales as gross rent.

Individual Location Sales Data used for Early Lease Terminations by Tenant (or Landlord)

A sales-based early termination option may be negotiated as part of a lease. Often referred to a “kick-out,” these lease provisions provide that if a tenant does not realize its sales performance (Productivity) in the middle of the lease term (usually 4th or 5th year), then it has the option to terminate the lease. In some cases, a landlord will also have a “kick-out” option so that it has the choice to terminate a tenant and replace it with one willing to pay more rent or with better prospects for higher sales or to bring a new retail concept in.

Individual Location Sales Data as a Factor in Predicting Tenant's Lease Actions

Owners evaluate a tenant's sales to assist in predicting a tenant's likelihood to extend a lease, or exercise a termination right. There are at least two ways an owner may approach this analysis. First, owners of multiple centers can evaluate among the same tenant's multiple locations. If a location's sales are significantly below or above the tenant's portfolio-wide average, then the owner has a better perspective on the tenant's likely intention. Second, owners may evaluate an individual tenant's location by evaluating the ratio of total occupancy costs to total sales at the location (or across multiple locations of the same tenant or the same category of tenant). Total occupancy costs are usually calculated as all the payments a tenant makes to the owner—including base rent, percentage rent, additional reimbursable pass-thru charges. These metrics are certainly specific to the tenant's category of business—for example, each of these will be significantly different: a big box

food/beverage/entertainment user vs. a grocery vs. an apparel manufacturer's outlet location. This ratio is nevertheless widely used throughout the industry by tenants and owners alike.

Individual Location Sales Data in Negotiating Modified Rents and Lease Economics

Another use of a tenant's sales data by an owner is to evaluate the economics of that particular tenant's lease. If the tenant and owner are negotiating the rents for an extension period, sales performance (productivity) data will be a significant factor in the negotiations. The sales themselves and also the data over time – or sales trend. If a tenant's sales have been steadily rising at a modest rate for years, then the tenant should be willing to maintain the current rent levels or perhaps agree to future increases. The opposite can be true, as well. If the tenant's sales have been steadily declining over several years, then the tenant may not be a long-term candidate for the center. Or, if the owner desires the tenant to extend then possibly the extension should be short-term only or at some reduced rent.

Aggregated Sales Data as a Factor in the Overall Quality of a Shopping Center Asset—and Possibly Its Potential for Sustained or Increasing Rents—and Potentially Future Increases in Value

Owners rate the overall productivity of a shopping center by generating a sales-dollars-per-square-foot metric. This metric is widely used in the industry to grade centers—these data are behind the more simplified ratings of centers as A+, A, B, C, or worse. This metric of productivity (sales per square foot) implies that tenants generally will be willing to pay certain amounts of rent relative to the available, potential sales. And, if higher rents are paid—or potentially paid—then the revenue to the owner will be higher. Higher future revenue increases the possibility of increased future net operating income (NOI) to the owner, and thus a higher asset value.

Typical Lease Requirements and the Current State of Reporting Compliance

Overview of Lease Requirements

The typical shopping center lease contains gross sales inclusion language, exclusion language, reporting mechanics, payment obligations and audit rights. Here is a brief description of each:

Inclusion language: Owners desire the inclusion language to be as broad as possible and inclusive of the value of any conceivable economic behavior of the tenant/occupant / sublessee / concessionaire: sales of goods, sales of services, revenue received for reservations, financing, extensions of credit, all forms of tender, even the vending machines in the employee break room. Most always, orders made by customers through the store systems will be included, even if the product is to be shipped to the customers home, work or other location.

Exclusions: Tenants negotiate to deduct or exclude certain amounts. Most negotiated leases will typically exclude returns of merchandise from customers previously included, credits or value given to customers for a return or exchange previously included, the amount of sales taxes collected and paid the government, sales to a tenant's employees through an employee program, amounts paid to credit card, payment card and payment processors, transfers of merchandise to another store or location, bad debt, sales of fixtures, furniture, equipment and other items not made in the ordinary course of business.

Special types of businesses will negotiate specific exclusions important to their business. For example, a restaurant may exclude delivery charges from sales. A drug store may exclude sales of prescriptions, alcohol and tobacco. Similarly, groceries may negotiate exclusions or limits on exclusions.

Commonly, certain important exclusion categories may have a negotiated maximum amount of the exclusion—often expressed as a percentage of the total.

Reporting: the reporting provision will state the frequency (monthly, quarterly, annually) and deadlines for reporting the adjusted sales—i.e. the amount of the inclusions and the deductions of the exclusions. In the past, certain signatures or certifications were negotiated to add veracity and importance to the reporting, not the least of which may have been the specter of personal accountability or even liability by the signatory. Some owners may continue to negotiate for these enhancements.

Payment: the payment provision will detail how payments are to be calculated and when the payments will be made. In a traditional percentage rent provision, a percentage of adjusted sales in excess of a certain threshold, or breakpoint, will be paid as rent to the owner. For example, a fine jewelry retailer may agree in its lease to pay 7% of adjusted sales in excess of \$5 million per year. The payment provision will also state whether

the payments are monthly after the monthly or annual breakpoint is reached or whether one payment is made after the year is ended. In all cases, the payment date trails the reporting period so that after month-end close the sales and the exclusion amounts can be compiled and calculated.

Audit: the audit provision allows owners to audit tenants' accounting records and related data and documents that are relevant to gross sales. Very often, the audit provision requires the tenant to provide store-level data reported as part of tax reporting to state and local governments. Support documentation on the negotiated deductions and exclusions along with summary level reports are also customary requirements.

Current State of Reporting Compliance

Tenants comply with these obligations, with rare exception. Failure to do so will result in default notices, owners exercising lease remedies, owners instituting audits, and, in some cases, assessment of penalties stated in the lease.

However, there is no standard reporting format across tenants unless an owner institutes a form as part of a lease exhibit. Even then, the form may or may not be followed as carefully as an owner may like. Tenants desire uniformity to achieve standardization and efficiencies in their accounting departments. In some cases, a tenant will report sales in accordance with the tenant's business practices, and will comply with the exact lease requirements only if an owner or property manager complains and demands strict compliance.

The means and methods used by tenants vary widely—by industry, size of the tenant's organization, business process sophistication—or even simple pragmatism. Several observations:

- a. Some tenants have a very manual process. The accounting team compiles printed sales reports that are mailed monthly to owners.
- b. Some retailers email digital images of an automatically generated reports.
- c. Some retailers automatically email automatically generated reports.
- d. Many retailers maintain accounting systems that track deductions from total sales. But, most do not track every exclusion that may be noted in the lease. Exclusion categories and calculations are limited by tenant's system capabilities and tenant's staff capacity.
- e. If a lease is "in the money" (i.e. rents are actually being paid on sales over the breakpoint), then a tenant may go back to see what other exclusions it might be entitled to besides the systematized ones.
- f. Some retailers digitally add an image of an officer's signature.
- g. Some retailers do not sign or authenticate the sales reporting unless specifically requested to do so, and then only as to the reports specifically requested.
- h. Very few tenants prepare sales report letters and have an officer physically sign, or certify, or attest each letter, each month, all year.

This is an area of commercial real estate operations with significant opportunities for technology to enhance and simplify the process.

Current State of How Customers Have Changed—and Are Changing—Their Behaviors:

The majority of retail sales occur inside physical stores—up to 90% by some estimates.¹ Nevertheless, there have always been sales transactions that take place outside the physical store—in whole or in part. These are the "customers you can't see."

Unbundling the Retail Transaction & The Rise of Customers You Can't See

¹ Steven Dennis, E-Commerce May Be 'Only' 10% Of Retail, But That Doesn't Tell The Whole Story
<https://stevenpdennis.com/2018/04/14/e-commerce-may-be-only-10-of-retail-but-that-doesnt-tell-the-whole-story/>

The retail transaction has always consisted of five distinct elements:

1. Presentation by the retailer of inventory available for sale
2. Selection by the customer of the product desired
3. Tender of payment by the customer
4. Fulfillment of the product to the customer
5. Return or exchange (if needed) of an unsatisfactory product

In the 1990's, a retailer only existed in its stores (and maybe a catalog division). The store experience was nearly 100% of the entire customer interaction with the brand. The brands needed the physical space -- it was indispensable. All of the 5 elements occurred within the physical store -- except for perhaps calling around to nearby stores to find a product not currently in stock. Even then, the catalog customers who ordered from home were customers you couldn't see in the stores.

In the 2000's internet commerce started as a separate thing altogether. At the beginning, it was essentially an electronic version of a catalog company. By 2008, many brands ran their e-commerce operations as completely separate businesses. Consumer and apparel companies were now selling directly to consumer outside of stores. All five of the transaction elements could now be transacted using the internet and shipping services, including U.S. mail. No longer was the physical store the limit on how much inventory could be presented to a customer. An internet site could show the inventory of an entire distribution center—25,000 times more inventory than a 1990's store. Now there were more and more customers that you couldn't see in the stores. The store owner's shopping center was no longer the only game in town.

In the 2010's customers no longer accepted the separate mindset. Now, stores, mobile and websites are all channels among which customers interact and conduct commerce. Customers now expect to be able to use any number of channels for different elements of the retail transaction—ideally, all seamlessly working together. Now, customers have visibility to the inventory in the store, plus the inventory in the distribution center—and now plus all the inventory in the entire store network for all the stores. This is over 150,000 times the amount of product in one 1990's store. At its full potential, a customer can use any platform or channel to shop the retailer's entire inventory and select the fulfillment format and location that best suits her. Now at each and every element of the retail transaction there are customers that you can't see in the stores.

The use of a brand's real estate assets—particularly stores—is changing and becoming more specialized. Stores are valuable; however, their value is no longer reflected merely by year-over-year store sales or “4-wall contribution.” Customers still use stores for all five elements of the retail transaction. However, more and more customers use stores for some but not all elements of the retail transaction. Some use stores to touch, see, and try on products. Some customers use stores to finalize and pay for an order that is later shipped elsewhere. Some far-away customers place an order online that is fulfilled from store merchandise. Some customers purchase and just use the store as a pick-up location. Customers also use stores as a place for returns.

Current State of Omnichannel—at least as of this moment

Here is the current definition of the what cutting-edge omnichannel retail is, according to Total Retail's 2018 Top 100 Omnichannel Retailers. During the first quarter of 2018, Total Retail measured publicly traded retail companies and judged them on the following seven omnichannel criteria (© 2018 NAPCO Media, <https://www.mytotalretail.com/resource/total-retails-2018-top-100-omnichannel-retailers>):

1. does it offer buy online, pick up in-store
2. does it offer the ability to search for in-store products on its website, including access to stock availability;
3. does it offer a shared cart across channels (e.g., mobile to desktop);
4. can loyalty points be earned and redeemed across channels;
5. can products be returned across channels (e.g., return online purchases in-store);
6. does it offer five or more channels for customers to engage customer service staff; and
7. is product pricing consistent across channels.

Asking the Right Questions when Negotiating a Gross Sales Provision in a Shopping Center Lease or Lease Amendment

Real estate professionals and their attorneys must engage in the discussion of each element of the retail transaction. What customer interactions with the physical store location will result in a transaction being included in gross sales? What customer interactions with the physical store location will result in a transaction not being included? A transaction being excluded?

The conversations and negotiations are now more complex than ever. What are the retail real estate property owners' expectations? What are the tenants' expectations?

Inclusion Language.

Inclusion language should be as broad as possible and not limited in scope based on the current tenant's business model. Services and experiences are under constant consideration by apparel retailers. Food & beverage tenants are offering delivery and order-online-for-carryout. Grocery tenants are offering click-and-collect and meal subscription services. Even some service providers are agreeing to report. For example, medical services, like urgent care centers, eye care / vision centers and dental. For other professional services sales reporting is still uncommon, but it can happen.

Exclusions that are standard and non-material.

Do not waste time and energy negotiating exclusion categories that do not matter. Just put them in and move onward. They are:

- a. Bulk sales, sales of furniture fixtures and equipment (FF&E) or sales of other items not in the ordinary course
- b. salvage sales of damaged merchandise
- c. vending machine commissions or similar accommodations for employees
- d. fees or revenue for issuing credit or extending credit and interest earned
- e. customer credit insurance

Deductions / Exclusions that are generally settled:

Be sure to clearly address the deduction / exclusion categories that do matter but are generally settled. Don't be silent. These are:

- a. gift cards and gift certificates are a form of tender and not sales, they are not included in gross sales until redeemed
- b. transfer of merchandise, exchanges of merchandise between tenant's warehouse or other stores and other similar movements of merchandise provided done for convenience of tenant and not for the purpose to consummate a sale made in, at or from the premises
- c. bad debt, uncollectible customer charges and bad checks and any penalty charged by Tenant for a returned check; however, if / when the amount written off is collected, then it shall be included in sales
- d. taxes collected separately from the customer and paid directly to the governmental authority, including sales, excise or local development taxes
- e. Fees, service charges, and expenses charged or withheld by issuers of credit, payment card issuers, payment processors (e.g. PayPal, Apple Pay, Square). This category used to be "credit card fees," but should be broadened to include all merchant fees and fees charged by payment processors or card issuers. Paypal, Apple Pay and Square are payment processors because a debit/credit card/bank account on file with them is the source of the payment. Paypal issues its own credit lines, too.

Deductions / Exclusions that Require Negotiation:

These are the categories of deductions / exclusions that matter and require negotiation. Discuss what the current viewpoint is, and what the viewpoint is likely to be in the future as technology and accounting policies will certainly continue to change. Dialog with your client. For the categories that matter on the particular transaction at hand, clearly state what is “in” what is “out.” For the sake of all those who will read your words and make payments based on their interpretation of what you meant, please don’t leave it ambiguous. The treatment of these need to be very clear:

- a. Caps of any kind need to be negotiated—there is no such thing as a “standard 1% cap” on anything. Understand the business need for the cap or need to have the exclusion uncapped. Is there a real business risk? If a cap is negotiated, then make the calculation method clear. Use an example when possible.
- b. If a food & beverage tenant, service charges and delivery charges. Are these offered at an operating loss for the convenience of the customer? What if paid to or shared with a third party (e.g. Uber Eats, Bite Squad, GrubHub/Seamless, Eat24, Waitr, etc.)? If so, define the metric (Gross profit, etc.) to be tested
- c. If a grocery or packaged food tenant, service charges and delivery charges. Are these offered at an operating loss for the convenience of the customer? What if paid to or shared with a third party (e.g. Shipt, Lyft)? If so, define the metric (Gross profit, etc.) to be tested
- d. If a food & beverage tenant, employee meals / sales to employees, and any caps or limits. This is a significant issue. These are always at a discount of some kind and may be at break-even or a loss from a profit perspective. (Define employees. That is, do other stores or any company employee qualify or what about friends and family members?)
- e. Fees, service charges, and expenses charged or withheld by issuers of credit, payment card issuers, payment processors (e.g. PayPal, Apple Pay, Square), and the caps that may apply. This is a significant issue in food, beverage, entertainment and hospitality as the overwhelming form of tender is via payment card.
- f. In apparel and specialty retail, sales to employees. These are always at a discount of some kind and may be at break-even or a loss from a profit perspective. (Define employees. That is, do other stores or any company employee qualify or what about friends and family members?)
- g. Inventory, transfers, and transfers. Sales fulfilled from inventory in the store to customers elsewhere. Sales at the store from inventory elsewhere, and returns. Refunds / Returns allowed provided the sale was previously included in reported sales of the store.
- h. Special products, product categories, or services. There may be other business and legal issues involved in certain products or services—for example, fuel/convenience stores, pharmacy/prescriptions, alcohol, tobacco, medical services, cannabis-related products

Record Keeping & Auditing:

- a. Basic records. The tenant must be obligated to keep basic financial records relating to the location’s performance for a period of three lease years. These include:
 - i. POS transactional level data
 - ii. POS Summary reports (day/week/month)
 - iii. Monthly sales summary reports (Sales Journal, General Ledger)
 - iv. Revenue line items from a store operating statement
 - v. Sales tax report at store level. Taxable and non-taxable transactions in certain states have different components. Varies by jurisdictions.
- b. Worksheet for the individual location for the time period covered showing the formula and the calculations in accordance with the formula.

- c. Supporting documents, when requested, can include merchant statements or GL entries showing the deductions or exclusions.
- d. Audit Rights. Elements to be negotiated may include:
 - i. Specific information or reporting detail around returns and internet transactions detail, where available.
 - ii. Specific enforcement or escalation remedies if tenant is chronically failing to report or respond to support requests.

Negotiations Never Occur in a Vacuum

Sales reporting will never be the most important issue in a shopping center lease deal--unless it is the most important issue!² The real issues in a lease deal are: How much money? For how long? For which space? For how much square footage? In what condition? And, maybe, who are the co-tenants?

In wrestling with omni-channel sales reporting issues, the context and other constraints are hugely influential. Here are some:

- a. Current technology: Does the retailer's point-of-sale system allow an online order to be placed? Paid for through the POS? Can the POS system access online sales records to even identify a valid internet return?
- b. Current business processes: Do all returns go back into store inventory? Store clearance inventory? Or, are returns an accommodation to the customer and the store ships some or all back to the fulfillment center? Does the store accept internet returns?
- c. Retailer accounting structure: How separated is the online sales channel from the stores sales channel from an accounting standpoint? Does the store finance team have data tracking the different types of Selection, Tender, Fulfillment and Returns? Might it in the future? On aggregate? Or by store? Or by store by transaction at all? What is the basis (policy) of the retail company's sales recognition of a sale transaction? Is it location of the order origination? Is it the location of inventory that fulfills the order? Etc.
- d. Historic leases: Many strong stores have old leases—they are still in place for these many years because the sales are strong. Old leases are often silent or use old principles no longer applicable (e.g. register tapes and Z-reports).
- e. Existing accounting policy: Owners and retailers both have existing accounting policies that include consistency as a necessary principle—one lease cannot shift the entire accounting policy or procedure for retailer or owner.
- f. Template leases: Many retailers and owner use template leases when they have multiple lease deals together. Re-opening a template for new negotiations is a business decision made with care.
- g. More change in technology: So far, in-store technology kiosks or tablets have not really caught on. And, commerce on mobile platforms continues to improve and be rapidly adopted. In what ways is mobile commerce connected to retailers' premises in shopping centers? Are shopping centers involved enough that owners have earned a share of sales? Retailers are experimenting with many new initiatives to build customer loyalty and engagement.

Putting It All Together

² If rents are based entirely on the sales volume from the premises, then reporting sales might be the most important issue.

Customers are rapidly changing how they interact with tenants digitally and physically. For retail real estate property owners, tenants, and the professionals who serve them, careful negotiation is even more essential—careful negotiation of the issues that matter with an understanding of the present and insight into the changes likely coming soon.

As of this writing, gross sales remain the nearly exclusive method for owners to measure the economic performance of a tenant's location.

However, retailers are trying to clarify the most important ways that customers interact with the physical store, create metrics to measure these ways, and determine the relative value of these interactions. Then, the retailers will use these values in their real estate decision making, of course. The relative value of the store asset will determine what resources a tenant is willing to commit to use the space—the rents, the capital to build it, the inventory in it. Retailers themselves are still at the beginning of understanding. Therefore, there is no systematic approach (yet) to valuing a location by aggregating the value of the store to different customers' different uses of the store location at different points in the customers' transaction journey.

For now, real estate professionals and attorneys must struggle with the uncertainty that a growing number of customer retail transactions utilize the physical store completely, significantly but not completely, only incidentally, or not at all! As total U.S. retail ecommerce approaches 20% of total U.S. apparel & specialty retail sales³ in the very near future...

The truth will be 1 in 5 is a customer you can't see.

³ Apparel Stores and Digital Commerce 2017: Trends and Benchmarks
<https://www.emarketer.com/Report/Apparel-Stores-Digital-Commerce-2017-Trends-Benchmarks/2002131>