Wednesday, October 23, 2019
3:30 PM – 4:45 PM

Workshop 6

Do Not Pass Go, Do Not Click-and-Collect $200
How Omni-Channel/Internet Sales Are Changing the Retail Real Estate Industry and Why Failing to Keep Up May Cost You Lots of Real (Not Just Monopoly) Money

Presented to

2019 U.S. Shopping Center Law Conference
Marriott Marquis San Diego Marina
San Diego, CA
October 23-25, 2019

by:

Kenneth S. Lamy, CRRP, CRX
President and CEO
The Lamy Group
1303 West Causeway Approach
Mandeville, LA 70471
kslamy@thelamygroup.com

Nadav Ravid
President and Managing Partner
Ravid Law Group
601 South Figueroa Street, Suite 4400
Los Angeles, CA 90017
nravid@r-lg.com

Gross Sales: To Include or Not to Include

The definition of "gross sales" has always been a subject of lease negotiations between landlords and tenants. From a landlord's perspective, all sales that bear any connection to a physical store should be treated as a store sale and, among other things, subject to percentage rent. From a tenant's perspective, not all sales are the same. For example, a customer that buys a pair of pants from a store and pays cash is not the same as an employee that buys the same pair of pants using an employee discount while also using a credit card, which is subject to a fee payable to the credit card issuer. Landlords have long recognized that some distinctions between gross sales do exist. Consequently, lease negotiators have been able to successfully establish certain industry standards about how to define gross sales by including a list of exclusions and deductions from the definition of gross sales to account for some of the differences in these types of sales. But with the rising impact of omni-channel sales, landlords and retailers are now having to re-think their perspectives on new types of transactions and issues that for the most part did not exist before.

"New" Sales and Transactions

Click-and-Collect Sales

A click-and-collect sale is one where the customer orders the merchandise online and picks it up from a physical store. A recent study shows that the primary reasons for using click-and-collect include avoiding delivery fees, receiving the items faster, and the assurance that the items will be available when shopping in-store (see Half of Americans use click-and-collect: ICSC Report, June 12, 2019).

Ship-From-Store Sales

A ship-from-store sale is one where the customer orders the merchandise online and the merchandise is delivered to the customer (typically the customer's home) using in-store inventory. Retailers are using ship-from-store technology to reduce distribution center shipping costs and speed up their customers' orders.

In-Store Devices

Some retailers are implementing technology within the store that would allow the customer to purchase merchandise that is not available within the store by using a store-provided device, such as an iPad, tablet or in-store kiosk terminal.

Returns

With the rise of online purchases, retailers are receiving higher returns of merchandise purchased online at their physical stores.

Win-Win Statistics (see Exploring New Leasing Models in an Omni-Channel World, ICSC Report 2017 and Maximizing Omni-Channel Opportunities with Click-and-Collect, Industry Insights ICSC Report, March 15, 2019)

More than one-third of consumers say they visit stores more often because of click-and-collect.

Almost one-half of consumers that use click-and-collect say they typically visit at least one other retailer in the same center where they pick up their order.

Between 20%-50% of click-and-collect customers end up buying something else at the same store. Customers spend over 50% more than the cost of the item they pick up at the store.

Customers that make returns of online purchases end up buying something new at the store- often exceeding the value of the return.

Use of Gross Sales Information

Measuring Productivity of Property

There are several major reasons that landlords are focused on gross sales. First, landlords want to ensure that their retailers are accurately reporting all of the sales that take place within their real estate. Landlords use the

sales data for several key purposes. These purposes are at the very heart of an owner's investment in the real estate asset—this information 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. 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.

Percentage Rent

Second, landlords want to ensure that they are receiving the benefit of their bargain for percentage rent purposes. 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.

Tenant Remedies

Third, 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% or 10% 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.

Kick-out

Fourth, a sales-based early termination option may be negotiated as part of a lease. Often referred to as 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.

Future Planning

Fifth, 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.

Future Rent Negotiations

Sixth, owners use the information 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 may 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.

Lease Requirements

The typical shopping center lease contains gross sales inclusion language, exclusion language, reporting mechanics, payment obligations and audit rights.

Inclusions

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, landlords will want orders made by customers through the store systems to be included, even if the product is to be shipped to the customers home, work or other location (see above).

Exclusions

Tenants negotiate to deduct or exclude certain amounts. Most negotiated leases will typically exclude returns of merchandise from customers previously included (see more on this above). With the rise of omni-channel, landlords and tenants are negotiating how to handle online returns that were not previously included in store sales. Other less controversial exclusions include 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 at a discount 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 comp meals, employee meals, 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 (A cap)—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. Some landlords seek to have the tenant 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.

Forms

Historically, there has been no standard reporting format that landlords and retailers use. To avoid disputes about the level of details to be provided, some owners require the retailers use a form attached as an exhibit to the lease. Even then, the form may or may not be followed as carefully as an owner may like. In contrast, some tenants desire their own 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 form. A couple of years ago, a new technology solution was introduced in an effort to create an "industry standard" to bring uniformity, efficiency and precision. It solves the lack of quality along with saving costs for both retailers and landlords including eliminating the manual data entry step.

Penalties

Failure to comply with the lease requirements will result in default notices, owners exercising lease remedies, owners instituting audits, and, in some cases, assessment of penalties stated in the lease.

Observations Based on Audits

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:

Some tenants have a very manual process. The accounting team compiles printed sales reports that are mailed monthly to owners.

Some retailers email digital images of an automatically generated reports.

Some retailers automatically email automatically generated reports.

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.

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.

Some retailers digitally add an image of an officer's signature.

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.

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.

The Evolution of Store Sales

The majority of retail sales occur inside physical stores—up to 90% by some estimates. 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."

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. The landlord and retailer must negotiate with balance from each other's viewpoint. That is, the physical store creates a place (Platform) to connect with their customer and the retailer brings unique merchandise / experiences for the customer which drives traffic to the property.

Items to Consider when Negotiating a Gross Sales Provision in a Lease or Lease Amendment

Real estate professionals and their attorneys must engage in the discussion of each element of the retail transaction. What customers interactions with the physical store location will result in a transaction being included or excluded from gross sales.

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:

i. Bulk sales, sales of furniture fixtures and equipment (FF&E) or sales of other items not in the ordinary course

ii. salvage sales of damaged merchandise

iii. vending machine commissions or similar accommodations for employees

iv. fees or revenue for issuing credit or extending credit and interest earned

v. 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:

i. gift cards and gift certificates are a form of tender and not sales, they are not included in gross sales until redeemed

ii. 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

iii. 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

iv. taxes collected separately from the customer and paid directly to the governmental authority, including sales, excise or local development taxes

v. 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. For the categories that matter on the particular transaction at hand, clearly state what is "in" and what is "out." The treatment of these need to be very clear:

i. 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.

ii. 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

iii. 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

iv. 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?)

v. 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.

vi. 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?)

vii. Inventory, transfers, and transfers. Sales fulfilled from inventory in the store to customers elsewhere. Sales at the store from inventory elsewhere and returns. See above for more on this category as it relates to omni-channel sales.

viii. 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 and Auditing

Basic Records

Landlords often require that tenants be obligated to keep basic financial records relating to the location's performance for a period of three lease years. These include:

a. POS transactional level data

b. POS Summary reports (day/week/month)

c. Monthly sales summary reports (Sales Journal, General Ledger)

d. Revenue line items from a store operating statement

e. Sales tax report at store level. Taxable and non-taxable transactions in certain states have different components. Varies by jurisdictions. Some retailers object to this level of information.

Some retailers do not want to have to create new records that they don't normally keep in the ordinary course of business. Therefore, they negotiate for some revisions to the landlord's record keeping requirements or include a catch-all that states that the retailer will not be required to provide any information above and beyond what the retailer creates in the ordinary course.

i. Worksheet for the individual location for the time period covered showing the formula and the calculations in accordance with the formula.

ii. Supporting documents, when requested, can include merchant statements or GL entries showing the deductions or exclusions.

iii. **Audit Rights**

Elements to be negotiated may include:

a. **Confidentiality.** Retailers require that landlords keep this information confidential. Many form leases state confidentiality by both parties.

b. **Penalties for under-reporting.** Typically, landlords will require that retailers pay for the cost of the audit if there is an error above a fixed percentage (e.g., 1%, 3%, 5%, etc.) of the amount reported. Some landlords seek to include a specific termination right if the error is substantial.

c. **Notice for Audits; Frequency.** Retailers require sufficient notice to produce the information. For some retailers, complying and participating with the audit process can be very time consuming and it may require use of

resources that retailers don’t have the capacity or desire to provide. Consequently, retailers seek to limit the frequency of an audit (No more than once a year for a store).

Conclusion

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.