

## **Why Turnover Retail Rents Make Sense**

By Michael Hart

For residential or office leases, we are accustomed to paying a fixed amount of rent each month usually with the addition of utilities and property management fees. However, for retail tenants, the range of rental types and other costs they pay is a little more complicated.

### **Retail Rental Types**

Retail landlords can choose from several different types of rental conventions for their tenants. The easiest to understand is fixed rent. The tenant is charged a specific rent every month regardless of how much the tenant sells. The second is turnover rent, sometimes called percentage of sales, meaning the tenant will pay a rent that varies based on their sales; more sales, more rent, less sales, less rent. Another option would be to have a base rent with a percentage of sales and charge the tenant whichever is higher. An example would be a landlord that charges a base rent of RMB 4,000 a month, but also charges 10% of sales with the caveat that they get the higher of the two. So, at a minimum, they'll collect RMB 4,000, but if the tenant's sales are RMB 50,000 in a month, their rent would go up to RMB 5,000. The challenge of course is tracking if the tenant is reporting their actual sales.

### **POS Systems**

When you see the cash register in a store, often called the POS (Point of Sale) system, you might not think about it, but in many cases, it is wired directly into the financial system of the retail center. A transaction on the third floor or basement level may not just be captured in the store, but also in the central finance office of the landlord (and sometimes in the retailer's own head office far away). In cases where the POS system isn't centralized, retailers are generally required to report their total daily sales to the retail center management team the following morning. There is a saying that a good retail landlord knows exactly how their tenant is doing before they are told. This might be because of a POS system, but good mall operators also should know from the number of visitors to their malls and by typical tenant type about what a shop should be doing in terms of total sales.

### **Transparency**

It isn't only a China phenomenon, but there is a pretty serious problem here, landlords and tenants often don't trust each other. Tenants often try to underreport sales to reduce taxes, but also to attempt to pay less in turnover rents. What often happens is that property management teams will directly inspect the POS systems in retail shops on a daily basis to try and assess if the retailers are being honest. As electronic payment systems such as WeChat have become more prevalent, underreporting has declined, those transactions get booked automatically in the POS.

## **Utilities**

In most cases, landlords also require tenants to pay for their own utilities including water, electricity and gas which are charged at a higher rate than residential utilities. It used to be that tenants would pay utilities the month after they occurred, but many landlords are switching over to a prepaid system, much like exists in residential developments in China. This means additional money invested upfront by tenants.

## **Property Management Fees**

Landlords often want to pass all of their costs off to tenants for items such as security, central utilities and cleaning. There is a reasonable level where this should happen, but it is pretty evident when walking through most properties in China, there are far too many property management employees doing far too little. As a result, property management costs are on the rise. It is interesting to note that in more developed economies, it is typical for tenants to be given audited statements of where the property management costs are being incurred. This is another form of transparency where the tenant says I don't mind paying, but show me what I am paying for – and keep your numbers reasonable.

## **Advertising**

In some cases, landlords, especially department stores, will also require tenants to pay an advertising fee, but in most cases, if tenants want extra advertising throughout the retail center such as directional signs, they can purchase it on an as needed basis.

## **Rental length**

One item that doesn't get enough attention is rental lengths. A typical rental contract in Tianjin for retail tenants can run anywhere from two to five years; restaurants may in fact be a little longer. One factor that determines an acceptable lease length, is how long it will take a tenant to be able to write off the cost of their decoration. Restaurants with large and expensive kitchens need longer leases, small retail kiosks, much less so. I have heard of landlords in some malls offering one-year leases for tenants that require a decent amount of decoration, with the idea that if sales aren't good, the landlord will just replace them. As a retailer, I'd steer clear of such short-sighted landlords who put all of the responsibility on tenants.

## **Conclusion**

In summary, occupancy costs for retail tenants can be quite substantial. Their total cost each month is a combination of fixed property management fees, costs that vary with sales such as utilities and then rents that can be either fixed, variable, or some combination of the two. All of

this is in addition to the decoration or fit out costs tenants must pay before opening. The most successful retail centers have found that when the center is well run and attracting plenty of shoppers, retailers are more than willing to pay a variable portion of their sales as rent to their landlords and landlords can benefit from the increased traffic they help bring. As both tenants and landlords in China continue to evolve, they will find a reliance on variable rents will allow both to be honest about how their businesses are doing and will result in a better experience for landlords, tenants and importantly shoppers.

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Michael Hart is the Managing Director of Griffin Business Management [www.griffinbiz.com](http://www.griffinbiz.com) a real estate related consulting firm with offices in Tianjin.