Retail Management

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Lecture – 23
Site Ownership Versus Site Leasing

Hello everybody, welcome to this NPTEL Swayam course on retail management. This is professor Swagato Chatterjee from VGSOM, IIT Kharagpur who is taking this course for you. We are in week 4, this is the last lecture on week 4 and we were discussing on site ownership versus site leasing. So, till now we discussed about the trading area, how to decide on that. Then we discussed how to decide on a site, what would be the location of the site. Now, we are discussing about should we own the site or should we lease the site if there is an option like that. What is preferable, owning a site or leasing a site?

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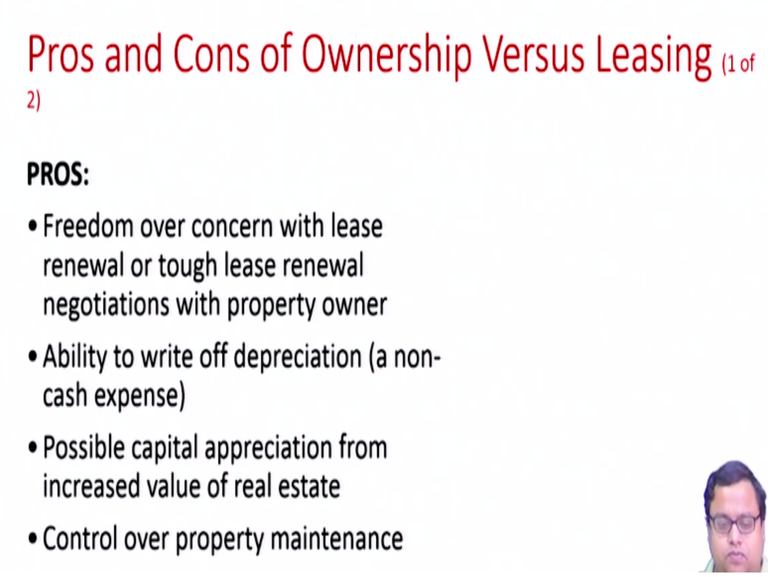

So, there are obviously pros and cons of owning a site. What are the pros? So, when you own a site you have freedom over concern with lease renewal or tough lease renewal negotiations with property owner. Leasing is a deal basically with the property owner and the person who is taking the lease. So, every year or 2 years or 5 years, what is the lease duration after that you have to renew the lease and there are lots of this kind of conflicts goes that whether you should renew the lease or whether the regulations will be tougher.

Sometimes it is the owner of the store who has an upper hand, sometimes it is the retailer who has an upper hand depending on who owns the retail space or who is more powerful the owner of the retail space or the retailer in terms of political, in terms of money because these are all sub judice area at the end of the day. Sometimes this becomes an important decision point that should I go forward.

Because if the deal does not come through or if the deal breaks or if there is a certain problem happens in the deal, then there will be litigations and that generally this retail aspect to avoid. Ability to write off depreciation. See you are not owning the site. So even if the site depreciates or even if there is a chance of writing off the depreciation, so after you write off the depreciation basically you can show that your income is lower.

Revenue might be higher, but the income is lower and that will give you some amount of tax benefits that will also help you show that okay this is an asset which has already absolutely depreciated so you may have the asset with a lower value in the books. So, those kinds of advantages are there. So, the ability to write off depreciation as a non-cash expense is not there if you have leased it, it will be only there with the owner. So that is also another pros of leasing. Possible capital appreciation from increased value of real estate.

If you own a particular retail store, then there is a chance that the capital will appreciate this particular place the actual money of the place will appreciate. So, the land costs might appreciate, the land value will might appreciate and that might actually help you in generating some amount of money. So, along with the retailing activity, you might make profit from the wealth ownership as well which is the asset ownership which is basically the retail space.

And you might also have control over the maintenance property, what kind of maintenance should be done. If you have lease deed, then you have to depend on the owner. You can only ask the owner that this is a place where the maintenance is required, that is a place where the maintenance is required, but whether that will be done or not it depends on the owner. But if you yourself own the place, then the control comes with you.

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What are the cons of ownership? One is difficulty in securing locations in our community and regional shopping centres because most of this neighbourhood shopping centres or regional shopping centres, they are already taken away either by municipality or by some other people who actually own the places. So, getting a space or buying a space becomes costly, either it is difficult, availability is low or you have to pay a lot of money to own the particular place in location and that is again where the choice.

In the last discussion we are talking about isolated versus planned shopping district. Generally, we will see that in a planned shopping district people take lease, people do not own, the retailers do not own the space. The real estate companies will own the space and retailers will take a lease out of that. But in the isolated place the retailers themselves will own the place because if you want to own the place in a regional shopping centre or neighbourhood shopping centre, it is difficult to get them.

Assets tied up in real estate could be used for retail expansion, inventory and store innovation. So, if you by chance have your own asset which is actually tied up in real estate which sometimes you have created but you could not sell it out, then you can use that for retailing activity, many real estate companies when the real estate also have their own fluctuations.

So, when the real estate is fluctuating and it is in a dip people are not buying the spaces, they can actually use those places majorly for retail expansion, but also for inventory. Inventory is a very good I would say investment or a side business which the real estate agents do because they have huge spaces, huge buildings and etc., which is not being sold. So, they might be using that for inventory or store renovation. So, those can also help the retailers.

If you are the retailer on your own who owns the space as well, then you can use that, otherwise if the owner is somebody else, also they can basically give it in the lease. Real estate activity can divert attention away from retail activity. So, if you by chance own the particular place, then one major problem is you are bringing in different business as well, you are focusing on real estate business as well.

Because see if it is in a remanet area, if you are coming up with a mall and you as a retailer will only use one particular floor of the mall and other floors of the mall you have built it because the space is available, but you are not using it for your retail store, you are renting it out to somebody else. Then you become a real estate agent, you become a real estate developer. You do not remain a retailer anymore.

So, your focus towards retailing gets shifted and that might impact your retailing activity. So, you have to make sure that when you are doing ownership, when you are doing this retail space ownership, the retailer has to make sure that there are two different heads, one is focusing on the real estate type aspect, one is focusing on the retailer aspect. The management should be different.

Difficulty in renting adjacent space or current space if location is no longer desirable. By chance if you have owned a particular location and the location become not so desirable because of many reasons; because of some new factory came up, often times for the development activity of a particular city, the particular retail space may become very not so desirable. Let us say you have made up a retail store.

There is a broad road in front and is a very busy road, but all of a sudden government decided that I will put a metro station here and your particular retail store is in between two metro stations, neither accessible by metro station A or probably a little bit away from metro station A, also from metro station B and there is a huge I would say the overhead bridge that is coming up for the metro or let us say for normal traffic which is impacting the visibility of the retail store and there is congestion down the flyover.

Over the flyover people are moving very smoothly but down the flyover there is congestion. So, if that happens and it is very common and when this happens a particular retail store becomes very undesirable. Now, if you own that store, if you own the store space, then what will you do? You cannot rent it out to another retail stores because they also know that this particular space is not desirable anymore.

So that creates a problem and if you are owning that place instead of if you are leasing the place you can just not renew the lease and move out from that particular place. So, this is a problem. So there are pros also, there are cons also of owning a particular retail store. There are certain strategic decisions that a particular company has to take.

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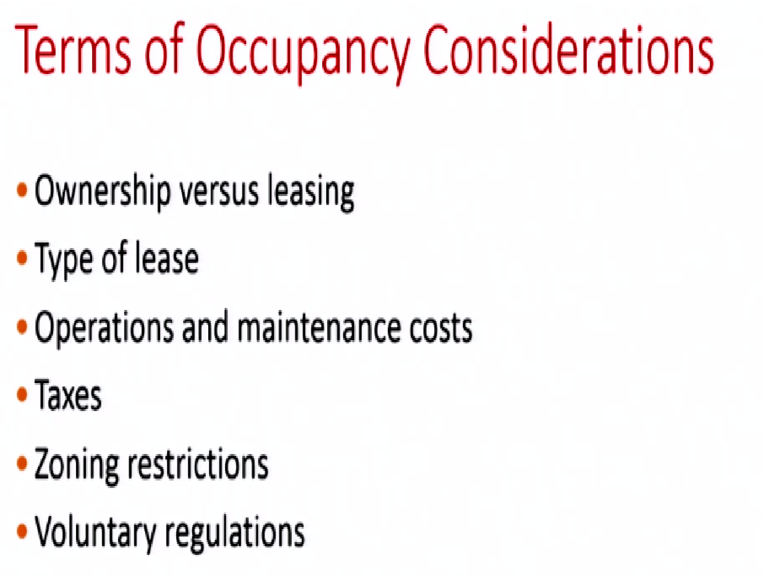

Now, if you are going for occupancy, the ownership versus leasing these are two options. There are other factors that also impact the occupancy is the type of lease and I will discuss about that. Type of lease, what kind of lease you are going for. The operations and maintenance cost of occupancy, the taxes, the zoning restrictions and the voluntary regulation. So, these are some of the things that we focus on. Let us focus majorly on type of lease.

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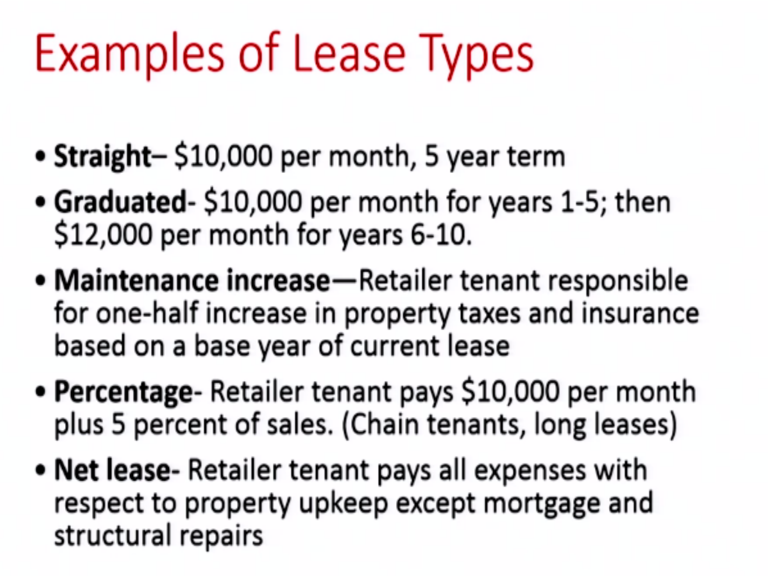

So, lease types can be of different types. What is straight lease? So, 10,000 dollars per month for 5-year term. So, between 5 year you cannot leave and over this 5 year 10,000 dollars per month you have to keep on paying that is a straight one. Then the graduated, why graduated because this person also knows that the location's advantage, as the retailers grows and takes more advantage of this particular space, I will be able to charge him more.

So, 10,000 dollars per month for first 5 years and then 12,000 dollars per month from 6 to 10 years. So, for the total 10-year term, first 5 years this much, second 5 years this much. So, I expect as an owner that this retailer will grow and be able to pay. Retailers also are okay because if they are able to grow using this retail space, they are also ready to pay a little bit more. Then sometimes the maintenance increases.

So, retailer tenant responsible for one-half increase in the property taxes and insurance based on a base year of current lease. So, there the cost of the rent will not change, but from that rent the owner will pay the taxes and insurances and interests. So, if that increases over time that increased insurance amount or increased taxes amount certain part of that will be borne by the retailer as well. So, now this is a better opportunity, better case for a retailer.

Retailer thinks that okay so I am paying for the space, but my increase in the rent is not happening just based on time there is a logic behind it, what is the logic? If the property tax increases or the insurance cost increases, then only I will. And property tax generally increases when the particular area becomes more economically developed. So, if it becomes more economically developed that will also help the retailer to gain more money and some part of that the retailer can pay for the property tax and the insurance so that is okay.

So that is a basically more I would say equitable kind of a deal if that deal is something that comes up between the owner and retailer who would have taken it as a lease. Then percentage, retailer tenant pays 10,000 per month plus 5% of sales. So, this is something which happens in case of chain tenants or long leases. Let us say I have a chain tenant, I have multiple places and I am giving you that.

So that is something then I probably will be interested in the sales that you are making also, which is generally not liked by the retailers because retailers think that okay my sales is something that irrespective of my profit you are making the money. So, you are making money out of my sales, not my profit, so then that creates a problem. You are basically then an agent which might not be liked by many retailers, but this is also another option.

A net lease, which is retailer tenant pays all expenses with respect to property upkeep except mortgage and structural repairs. So, most of the basic repairs and basic upkeeping of the particular space will be taken care by the retailer. What is the advantage of that you have this kind of lease? You do not have to go and ask the owner that you do this maintenance, that maintenance, you will do on your own, maintenance on your own.

The mortgage that means the money that you pay to the bank and the structural repairs which are major costs these will be incurred by the owner from the fees or from other sources, but that is not retailer's responsibility. Otherwise, retailer's responsibility is to keep an upkeep of this place. In whatever way took this particular store, you should be able to give back in that same way; if it is not all superficial repairs, all the upkeeping, cleanliness, these are stuff that has to be maintained by the retailer themselves.

So, this is probably a look very good kind of lease agreement which the retailers will want to do because they do not have to depend. Upkeeping is very important because how it looks and what kind of vibes it is giving is very important for the sales of the retailer. So, if they have to depend on somebody else for the upkeeping, then that creates a problem for the retailer, so they will take care of the upkeeping on their own. They might have to that is why pay a little bit of less amount of money per month rate and they will keep the upkeeping.

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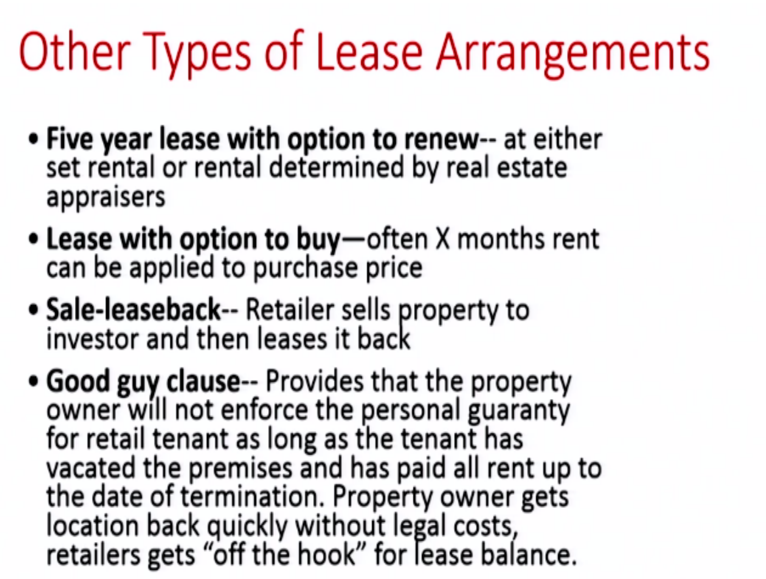

What are the other types of lease agreements? So, five years lease with option to renew at either set rental or rental determined by real estate appraisers. So, somebody, either third party or they themselves will set the rate of every renewal. Lease with option to buy, this is a very interesting option. While you are giving the person a lease, often X months' rent can be applied to purchase price.

So, you are giving this particular retailer as a rental lease, but they have an option to buy. If they find that this place is good, then they can buy it. So, that is an advantage both for the property owner plus property owner do not have to find out another customer to sell it off or to give it for lease and that is also advantageous for the retailer because retailer can actually test the trading market or store location, whether it is good enough or not and if they find it good enough, they can invest.

So, that investment cost is a little bit higher, but the risk is mitigated. Then the sale-leaseback which is retailer sells property to investor and then leases it back. So, you have created the store space, the huge building, but you do not have the money or you are not in a real estate business, the problem of ownership that we discussed. So, then what I do is I will sell the whole stuff to somebody, but I will take one part of that particular property at a lower cost of lease.

So, then the selling cost will be also low, but the leasing cost will be further lower, so that is another option. And the last one is good guy clause, provides that the property owner will not enforce the personal guarantee for retail tenant as long as the tenant has vacated the premises and has paid all rent up to the date of termination. Property owner gets location back quickly without legal costs, retailer gets off the hook for lease balance.

So, basically the personal guarantee that you have to pay, which is when you take a lease you have to pay a certain amount of money as guarantee which remains there, there is no interest on that, you do not get interest on that and that is a huge amount of money if the retail space is high. Now good guy clauses by chance if you paid all the rent and if you have given back this particular retail store to the owner at a good shape in whatever shape you have taken it, then that money will be returned to you without any kind of legal problems.

So, that is a good guy clause. Often the owner under lease basically actually come together and write the document in such a way such that this cause is there. So, this good clause, whether this guy is a good guy or not can be actually measured by a third party. If the third party says that he has taken all the special care of your space, it is like when you rent a house in any particular place you have to give certain security deposit.

Now often times the tenant and the owner will have a problem in terms of the security deposit how much should be deducted and etc. Now, this is a good guy class. If you have a third party person who will make the measurement that the property has been taken care of properly, then you will get back all the money that you have kept for the security deposit. So, these are all different kinds of arrangements of leasing and ownership.

We have talked about a lot in site selection and etc. In the next week, we will talk about supply chain in retail management where we will move away a little bit from marketing activities and it is a strategy kind of a course, so supply chain and finance will also come into the picture. So next we will discuss about supply chain management under retail. Thank you very much for being with me. See you in the next week.