

WHAT'S NEW IN THE RETAIL REAL ESTATE MARKET AND WHAT IT MEANS TO YOUR RETAIL CLIENT

Maryn L. Miller, Esq.
General Counsel, BCBG Max Azria
Los Angeles, California

Introduction

The market has changed, resulting in an excess of retail space and a shortage of attractive tenants. Advising the retail tenant means understanding these changes and what they mean to the retailer, as well as to the landlord.

A. What's New In Retail Real Estate Properties?

Despite the slow economy, new malls and centers are still being built; understanding the market and advising you client on leasing new properties.

1. **New properties** – special considerations in lease negotiations
2. **Outlet malls** – still on the rise, how to provide your client with the benefits but limit the risks
3. **'Lifestyle centers'** – protecting the tenant from their yet unknown risks

B. The Changing Face of The Landlord: Consolidation of Properties Among Landlords

The majority of the major malls and centers are now operated by just a handful of major landlords and the trend of consolidation is continuing with no sign of a slowdown. What does this trend mean to you retail client and what unique issues should be considered in advising a retail tenant client in this market.

1. **Package deals** – are they worth it?
2. **Cross-default provisions** – their ramifications in the new market

C. Making the Most of a Difficult and Uncertain Market

Landlords need tenants as vacancies grow, but they are no longer willing to accept the risk of tenants who are not creditworthy. What the parties are willing to trade.

1. **Tenant Incentive Packages and What Landlords Want in Return** – Landlords are offering valuable incentive packages to lure tenants, but in return they are seeking increased security
2. **Advising the Tenant in a Financial Crisis** – How to assist a client who is facing a financial crisis

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**WHAT EVERY LANDLORD AND TENANT SHOULD KNOW
IN TODAY’S RETAIL REAL ESTATE MARKET”**

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It is no secret that the retail industry and the retail real estate market are going through a difficult period. In the past years, the market has suffered from the fall of the dot.coms and the underperformance of the new media industry, the over building of mega-stores, the saturation of major chain retailers, a slowed economy, and the fall-out of the tragedy of September 11. Any hope of short-term turnaround is tempered by the current threat of war and domestic terrorism.

All of these factors have changed the playing field of landlord and tenant negotiations. There is an excess of retail space and a shortage of attractive tenants, and above all, the players are cautious and risk adverse. By understanding the climate and a retail tenant client's needs, many hazards and risks can be avoided or limited minimizing the tenant's exposure and maximizing its security.

A. What's New In Retail Real Estate Properties?

Despite the high vacancy rate and the soft retail real estate market, there is significant growth of new retail properties, largely fueled by historically low interest rates and continued optimism for the future. Whereas the trend toward supersized stores and mega-malls has slowed, there is a continued growth of malls and centers, particularly outlet malls, as well as a focus on the development of "lifestyle centers" aiming to satisfy a number of the consumer's needs in one convenient location.

1. Special Considerations for New Malls or Centers

Leasing a site at a new or untested mall or center can present specific risks to a tenant, which can largely be controlled through effective lease negotiating. A new mall with high expectations may have an allure to a retail tenant, but the past years have demonstrated that even the most exciting new projects can result in tremendous loss to the landlord and the tenants. Moreover, these sites are competing in a difficult market for desirable tenants and they do not have a track record to back them up. These factors allow a tenant to negotiate specific provisions which will reduce the tenant's risk, such as payment of percentage rent only, rent free periods, increased construction allowance and kick-out provisions whereby a lease can be terminated with no further liability if the store does not meet expected sales levels.

Other provisions are equally important such as co-tenancy provisions. It is well recognized that a mall needs strong anchor tenants to attract customers. If a retailer enters into a lease believing that its co-tenants will be major, attractive retailers and the mall is ultimately unable to secure such tenants, then the retailers who are occupying the mall can expect to suffer losses. The best way to avoid such a situation is to negotiate co-tenancy provisions whereby a tenant is relieved of obligations unless and until specified co-tenants are open and operating in the center. Such provisions can be constructed in numerous ways, either granting the tenant a right to terminate the lease if the agreed upon co-tenants do not open in the center, or by conditioning various rent provisions or opening dates on the opening of the key co-tenants. The inclusion of a co-tenancy provision is a useful tool for tenants to protect themselves from becoming tied to a lease in an unsuccessful new mall.

2. Outlet Malls

The continuing growth of outlet malls is not surprising. They satisfy the retailer's need for a site to offer excess inventory at reduced prices and allow the retailer to reach a consumer that might not otherwise visit its full-priced stores; they require significantly less start-up investment from the landlord due their scaled-down, bare bones nature and quick occupancy; and they appeal to the consumer's desire to take advantage of the abundance of sale priced merchandise in one location.

Despite the allure of outlet sites, a savvy retailer will recognize that the current appeal of outlet stores may be temporary, and a savvy attorney will protect the tenant client to the extent possible by negotiating protective provisions such as percentage rent only deals, including a kick-out provision if the store does not meet expected sales, and structuring short-term leases to the extent possible.

3. Lifestyle Centers

A newer trend in the retail real estate industry is the growth of lifestyle centers, which, in addition to offering retail stores, offer the consumer entertainment, eateries, fitness centers, video stores and personal services. These centers are typically built with an open, outdoor feeling aimed at being attractive to a consumer not just as a place to buy merchandise, but also as an enjoyable place to spend free time.

While it is still early to predict the fate of such lifestyle centers, there is some suggestion that while these sites attract visitors, that does not necessarily translate into strong revenue for the retail stores. The numbers indicate that consumers spend significant dollars at these centers; however, there is a suggestion that the bulk of the spending is on food and entertainment rather than on retail purchases, and that the typical

visitor to such a center is looking to be entertained rather than to make significant purchases.

The unpredictable performance of retailers in such centers should be kept in mind in negotiating a retail space in or near a lifestyle center. Increased foot traffic does not necessarily equate with increased revenue. As such, risk-reducing lease provisions such as percentage rent only provisions, kick-out clauses, co-tenancy guarantees and short-term leases are of particular value in negotiating a space for the retailer in a lifestyle center.

B. The Changing Face of The Landlord: Consolidation Among Fewer Landlords

Another rampant trend in the retail real estate industry is the consolidation of malls under fewer landlords. As any multi-site retailer knows, where there were once numerous landlords of varying sizes, the majority of the major malls and centers are presently owned by a handful of companies, and this consolidation is continuing without any sign of a slowdown.

The consolidation of properties allows a major landlord to use its stronger properties to benefit its less desirable and lesser performing properties, particularly through the use of package lease deals and cross-default provisions in leases. An understanding of the ramifications of package deals and cross-default provisions is critical in adequately advising a tenant client in the current market.

1. Package Deals

The fact that the major landlords now dominate the market has led to an increase in landlords tying the lease of new or lower performing properties to their hot properties in package deals. Thus a tenant may find that if it wants a location in a top

mall, it will be required to take one or more other locations in riskier or poorer performing centers as well.

While the lure of a prime location in a top mall may be tempting, it is critical a tenant understand that performance of the prime location will need to support the packaged store or stores as well, and often a careful financial analysis may lead to advising a retail client to pass on such opportunities unless the package can be successfully negotiated to reduce the retailer's risk in the less desirable locations.

2. Cross-Default Provisions

Another area of retail store leases that has taken on new significance in light of the consolidation of retail properties is the inclusion of cross-default provisions in leases. In a further effort to use its strong sites to protect weaker sites, landlords are more frequently including cross-default provisions in leases whereby a tenant will be in default of a lease if it defaults under any other lease between the parties.

In the current economy, these provisions can be devastating to a retail tenant. Many retailers are forced to make difficult decisions in a struggling economy, such as closing doors or allowing a default on a store lease. The cost analysis in making such a decision would traditionally be limited to the consideration of the already severe potential damages recoverable by the landlord under the lease in regard to the single location. However, where there is a cross-default provision, the landlord's leverage is no longer limited to the damage remedies provided by the lease. Instead, the landlord has the added and potent leverage of selectively threatening to terminate, or terminating, the top performing leases of the retailer, not only forcing the retailer out of a top performing space, but subjecting the tenant to the potential damage remedies provided for in those

leases as well.

In addition to giving the landlord tremendous leverage over a tenant in negotiating failing properties, cross-default provisions also allow a landlord to ‘cherry pick’ in regard to which leases it will exercise its cross-default rights. Thus, a tenant who has defaulted on a lease on an under-performing store may find its leases for prime locations being selectively attacked, while the poor performing locations are left untouched. Often these poor performing sites are the very locations that the tenant took as part of a package deal in order to obtain the top locations that have now been selectively called into default.

Obviously, it is to any tenant’s advantage to avoid the inclusion of a cross-default provision whenever possible. However, short of avoiding the clause altogether, at the very least, the lease should specify that the cross-default provision is only applicable to the other leases in effect specifically between the named parties at the time of the signing of the lease. Otherwise, a cross-default provision that may initially seem relatively harmless to a retailer who only has one or two locations with a landlord, may take on much bigger significance if the leased property is acquired by a larger landlord, or the landlord acquires additional malls in which the retailer leases space. In light of the recent consolidation of properties under fewer landlords, it is highly foreseeable that a lease containing such a provision will be acquired by a major landlord with whom the retailer has additional leases, and the typical wording of the provision makes no exception in regard to leases acquired in such a manner.

C. **Making the Most of a Difficult and Uncertain Market**

With the slowdown in the economy, retailers have curbed expansion or are

cutting back on retail sites, new retailers are scarce and unsafe gambles for landlords, the sublease market is creating competition for the landlord, and the situation shows no sign of changing in the near future. Moreover, landlords have learned an important lesson in the recent years where tenants who appeared to be low-risk ended up costing the landlord significantly. The result is too much vacant space and not enough attractive tenants.

1. Tenant Incentive Packages: What Landlords Want in Return

Landlords are competing to fill space and this means they are often willing to offer attractive incentive packages to induce retailers into entering into a lease. Such packages include increased construction allowances often with more favorable pay-out terms, free rent periods, caps on rent increases, and of course, lower rental rates.

While landlords are anxious to attract tenants, they are no longer willing to accept the risk of a tenant who is not creditworthy. The result is that while a landlord may offer attractive incentives, the landlord is likely going to demand a concession in return, typically in the form of increased security. This security can take the form of a guarantee, increased security deposits, or often a letter of credit, which if done properly gives the landlord security even in the event of tenant bankruptcy.

In addition to requiring additional security, landlords are more likely than ever to ensure that a lease provides that any incentive given is contingent upon tenant's full compliance throughout the term of the lease. Thus, a tenant who breaches the lease down the line might find itself liable for refunding all or some of the value of the incentive it received.

While there is no single best way to negotiate incentive and security provisions, it is important when negotiating on behalf of a tenant client to keep in mind

that providing the landlord with additional security has significant value and can be a strong negotiating point in this market.

2. Advising the Tenant in a Financial Crisis

Even retailers who were once thought invulnerable are now facing economic difficulties and even financial crises. The manner in which such crises are managed by the tenant and its counsel can drastically affect the end result to the client.

In the current economy, retail tenants may be under financial or cash flow restrictions that result in late rent payments, delayed store openings or other defaults under the lease. The landlord typically has an immediate right to exercise its remedies under the lease in such situations; but this is not necessarily in the landlord's best interest as finding a new tenant or collecting from an evicted tenant pose significant risks to the landlord. The landlord's decision on how much leeway to allow the tenant and when to pull the plug can be greatly affected by managing the situation pro-actively and providing the landlord with a sense of security.

In the event that a retail client is suffering economic difficulties and is unable to meet its obligations, it is important that landlords who might be affected are notified in advance of expected delays in payments or store openings, and are kept informed of the status of the matter throughout. While no landlord is willing to remain in a situation that appears destined to result in a loss, they may well be willing to work with a tenant who can show that it understands its financial problems and has a specific plan of rectifying the problems in a set period of time. For example, a landlord may waive late penalties, which typically only compound the problems of a cash-stressed tenant, extend cure periods, or may delay initiating the legal remedies available for the default.

If handled well, a tenant can not only control much of the fall-out that results from cash shortages or difficult financial decisions, but the tenant may be able to secure assistance from the landlord in the form of rent deferments, temporary percentage rent deals, and rent offsets against construction allowances or direct payment to contractors from construction allowances. The key to assisting such a client is to quickly and effectively prepare a plan to present to a landlord before the matter comes to the landlord's attention as an on-going problem via the landlord's internal channels. While there are no certainties in this market, it is important to remember that the landlord is feeling the same stress and risk of the uncertain economy, and that it may be willing to work with a tenant if it is confident that further crisis can be avoided.