Mall Landlords and Retailers Have Diverged

By Michael Hart

Winter in northern China can seem a bit dark, cold and desolate. One way to survive the season is to meet friends for an outing in a climate-controlled shopping mall over a hot meal or a warm cup of coffee, but recently the scene inside a number of the city's malls is nearly as bleak inside as the weather is outside.

China's economy may have fared relatively well as compared to other major economies, but relatively is the key word. For retailers and mall owners 2020 has been a big challenge. While there is plenty of activity in a number of malls, others have seen a large range of shop closures and anchor tenants aren't bringing in folks like they used to. One mall on Nanjing Road, a major shopping street in the heart of the city, has seen shops close on nearly every single floor of the mall. Empty units are starting to outnumber occupied ones. At another, a dozen restaurants have opened and closed in their B1 food court, reportedly because the tenants haven't met sales targets set by the landlord. Neither of these bode well for the malls or retail in general.

The Agreement

My two decades in commercial real estate taught me that retail landlords need to know how their tenants are doing and find ways to help them succeed. I also learned that tenants needed to work hard to pay their fair share of rent and make themselves relevant to the overall performance of the mall and earn their place in it. It seems both sides have forgotten these rules.

How Landlords Make Money

It may seem obvious, but it's worth quickly reviewing how shopping mall landlords make money. Landlords make money by charging tenants rents (base rents and or turnover rents) and by charging tenants or other groups to do promotions in the mall either by renting specific space or selling internal or external advertising locations. Landlords also charge tenants property management fees to pay for things like common area cleaning and air conditioning and cover their own staff expenses. Water and electricity used by tenants is also charged back to them directly. Empty units not only hurt the image of the mall; they mean remaining tenants have to cover common area fees for the whole property. A tenant who only can afford to pay their property management fee, might still be an asset in a tough market.

How Tenants Make Money

Again, it is probably straight forward, but worthwhile to review how tenants make money. Tenants only generate a profit if their sales, minus all costs including rents, property management fees, utility costs, staff salaries, head office costs, product costs and franchise fees generate a surplus. If you've been paying attention when visiting any mall in Tianjin this year, you've seen quite a few stores close. This means that these stores are not making enough to cover all of these costs thanks to falling sales. Tenants who have seen sales fall during the pandemic have not had the power necessarily to decrease their other costs.

Customer Experience Needs to be Good

The debate about how e-commerce is killing traditional "bricks and mortar" stores has been around for a few years, and yet, some retailers keep opening physical stores. I'm not sure why some of them try. What I've found is that the customer experience in some stores has gotten worse, not better. A recent trip to drugstore where staff used to pounce on customers the minute they walked in – which I found annoying, has now completely changed their strategy. Now staff stand around talking to each other acknowledging customers only to encourage them to check themselves out at the self-service kiosks. I wonder if they realize they are making themselves irrelevant. As a landlord, I would be asking what is the value of this store and how they add value to the mall. With retailers like these, perhaps this is why some landlords see their tenants only as an income stream that can be interchanged with any other.

Up or Out

For several stores we manage we've been in lease negotiations recently and I'm surprised at how aggressive some mall managers have been with trying to increase rents on tenants who want to stay. One leasing manager disclosed they had suffered in 2020 because of Covid and then suggested we pay 20 percent more in the next leasing cycle. It was an odd, but not surprising expression of his lack of understanding that the reason his mall had suffered was because tenants had also suffered. Ideally most chain retailers want to increase their total number of shops, not change one location for another, so if a brand is closing in a mall, they are basically giving the mall a vote of no confidence at the current rental level. Many mall managers seem to want retailers to increase their rents each year or move on. This lack of perspective comes from employees who think each year will always be better than the previous one.

Moving within a mall

One of the largest costs for a retailer is decorating their store. For a fashion retailer this could be RMB 50,000 for a small shop and four or five times that for a restaurant with more complicated kitchen, counter area and customer seating area. I've recently seen some landlords shifting tenants around, with the entire cost coming from the tenant. On paper it seems like an easy way to freshen up the mall, by shifting retailers to a new location within the property, but it isn't cost free by any means. I predict many of those retailers will struggle to stay afloat having invested large amounts of money to effectively stay in the same property, and to be moved away from locations where customers knew to find them.

Delivery

In terms of the delivery business, let me start by saying that everything I've seen in with Meituan and Eleme in China and DoorDash and Grubhub in the USA lead me to believe in the current format, these businesses don't make money for themselves. I also don't think they generally make money for the restaurants that use them. And when used in conjunction with malls, it is an even stranger combination. Some malls bar delivery drivers from coming inside, even after the Covid scare has largely passed meaning it is hard for restaurants to quickly get their orders out. Furthermore, these restaurants are generally relying on these delivery services because they don't feel they are making enough sales to make a big enough profit at their location. So, effectively, malls are trying to keep out the revenue that restaurants are trying to earn to pay rents to the malls. Odd. Additionally, mall owners often want restaurants to report their delivery sales, so they can charge the restaurants a percentage of rent on those sales – which the mall owner shouldn't rightfully have, because the sales necessarily were generated from outside the mall. This relationship is very dysfunctional.

Conclusion

The year 2020 has been a tough one for most businesses and mall owners and tenants more than most. For their mutual benefit they should be working together, but I've seen more short-term thinking and ill-timed strategic changes that lead me to believe that a number of retailers who survived 2020 will struggle in 2021 and if they fail, their landlords may be next. Landlords need to realize their success depends upon the success of their tenants. This means they need to be looking to develop healthy relationships with them and find ways to help them succeed, not consider them just a puzzle piece that can be moved around or swapped for another piece.

Tenants need to also realize they need to deserve a place in the mall and pay a fair rent. Reducing staffing levels and going to self-check out defeats part of the purpose of having a physical store. Both parties will need to think clearly about delivery and its role for tenants and landlords. I'm not convinced that if the economy comes back to normal in 2021 that retail will follow. The damage done by the pandemic is going to be long lasting. It would be best for all parties involved to sit down and try to find a common strategy.

This article was published in ***Business Tianjin Magazine*** in January 2021.

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