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Empty Mall Stores Trigger Rent Cuts

Remaining Tenants Point to Occupancy Guarantees to Shave Overhead Costs or Escape Leases

By ELIZABETH HOLMES, VANESSA O'CONNELL and KRIS HUDSON

Retail chains are using the fine print in their leases to demand rent reductions, eking out critical savings and pressuring mall owners already struggling with vacancies.

Gap Inc., Williams-Sonoma Inc. and AnnTaylor Stores Corp., among others, are poring over their leases and dispatching staff to track store closures that trigger "cotenancy clauses." The clauses, relatively common in retail leases, let tenants demand cuts in rent -- or, eventually, a penalty-free pullout -- if key tenants or a specified numbers of stores leave the center.

Chico's FAS Inc. has saved $8.1 million so far through its rent-relief negotiations, including the aggressive enforcement of cotenancy clauses. Chico's, which has more than 1,000 stores, relies on its regional sales managers to police the malls. They study the cotenants named in the leases of each store, then walk the malls on the lookout for violations, taking photographs as evidence and reporting back to the corporate real-estate team.

Charming Shoppes Inc., with brands such as Lane Bryant and Fashion Bug, estimates that it will save roughly $10 million this year by pursuing rent relief, including the use of cotenancy clauses.

The breach of a cotenancy clause typically allows the retailer to pay as little as half the rent while the landlord searches for a new tenant to replace the one that departed. If none is found within the allowed grace period of a year or more, the retailer can break its lease without the usual, hefty cancellation fee.

Retailers that want to stay put are using the triggered clauses to negotiate multi-year rent reductions from their landlords, often in exchange for adding more years to their leases. Some cotenancy clauses allow retailers to pay lower rent if a mall or shopping center's occupancy falls below a certain threshold.

Rent is among the biggest expenses for retailers. As sales continue to drop, the fixed cost of rent eats away at already thin profit margins. The average specialty retailer spent roughly 12% of sales on rent last year, up a percentage point from 2007. Citigroup estimates that the figure could reach 13% this year.

Reflecting a decline in revenue, Chico's rent as a percentage of sales reached 10% in 2008, up from 7% two years earlier.

For commercial landlords, the cotenancy demands are one part of a miserable picture as they suffer through the current recession.

According to data released Wednesday by real-estate research company Reis Inc., the average lease rate at shopping centers -- defined as open-air centers and big-box centers as opposed to enclosed malls -- in the top 77 U.S. markets declined in the second quarter for the fifth consecutive quarter. In the 29 years it has tracked the figures, Reis says it has never seen a stretch of declines that long. At enclosed malls, average lease rates declined for the third consecutive quarter. Store vacancies are also hitting multiyear highs.

With a recent boom in the construction of open-air shopping centers -- which depend on chains of smaller shops rather than department stores -- many retailers insisted on adding clauses requiring that other key specialty retailers be signed as tenants, to ensure ample drawing power. As chains now either shutter stores or curtail expansions, use of the clauses is on the rise.

"We all sort of locked arms and said, 'Let's jump in the pool together,'" says David Zoba, senior vice president of real estate for Gap. "Now some of us are getting out of the water."

The result is a ripple effect, as failures trigger cotenancy violations, which in turn lead to canceled leases, more vacancies and more violations.

Bankruptcies have led to many of vacancies. Last year, at least 27 major retailers filed for bankruptcy protection, followed by another 13 so far this year, according to BankruptcyData.com. Many of these companies, including Linens 'n Things Inc., Mervyns LLC, Circuit City and Sharper Image Corp., eventually opted to liquidate, leaving vacant stores.

That can trigger cotenancy benefits for other retailers, says Matthew Bordwin, managing director at KPMG Corporate Finance LLC, which represents retailers looking to restructure their leases.

"Today, when you're running a retail portfolio, it's death by a thousand cuts," says Glenn Rufrano, chief executive of Centro Properties Group, which owns 622 shopping centers in the U.S. and 122 in Australia and New Zealand. "You could have a pure vacancy, a bankruptcy and liquidation, tenants asking for rent relief, or cotenancy cuts because of the loss of a major tenant."

It is not just apparel retailers pressing for rent relief. Blockbuster Inc. is "aggressively renegotiating" its U.S. leases as part of its effort to reduce overall expenses, says spokesman Randy Hargrove.

In January, Starbucks Corp. began reaching out to landlords at its more than 9,000 global company-operated cafes about rent reductions.

Write to Elizabeth Holmes at elizabeth.holmes@wsj.com, Vanessa O'Connell at vanessa.o'connell@wsj.com and Kris Hudson at kris.hudson@wsj.com