



PDF of this article



Mail this article

# Retail Landlords Face Quandary

*Even as store sales decline, their property taxes climb*

By **Darlene Sullivan, Esq.** as published in **National Real Estate Investor**, May 2009

**C**urrent market conditions have led to tenant bankruptcies, store closings, vacancies, deals placed on hold and declining sales in many retail centers in the U.S. Given these pressures, it should be easy to argue that property values have declined. But how do you prove to the assessor that your property has hit a slump in value when the property's trailing performance does not reflect current fair market value?

A tenant's retail sales are commonly reported to landlords and provide a tool to measure the viability of a tenant and the center in which the store is located. But just showing a drop in tenant sales may not provide enough evidence to convince the tax assessor to lower a center's taxable value.

The taxpayer must be able to demonstrate in actual numbers the relationship between market rents the center can charge and the retail sales performance of the center's tenants. By taking this approach, an owner can empirically show the current rents that should be applied to the assessor's valuation analysis.

## Are rents too high?

Occupancy cost is the term used to describe rent plus expenses that retail tenants pay to their landlords for maintenance of the common area, utilities, taxes and other costs. Tenant occupancy cost ratios are calculated by dividing the tenant's total occupancy costs by the tenant's total sales.

Occupancy cost ratios vary for each property type and merchandising category. Large national discounters have occupancy-cost ratios as low as 1.5%. High-margin retailers, such as jewelry stores in regional malls, can have ratios in excess of 20%.

Median occupancy costs at U.S. neighborhood centers are 8% to 9% of sales, while U.S. regional malls typically range between 9% and 16% of sales. A good rule of thumb is the higher the retailer's markup, the higher percentage of occupancy costs they can afford.

Doing this math gives owners a powerful tool to help determine if tenants are paying rents above, at, or below sustainable market levels.

During a downturn, it is imperative that an owner demonstrate the effects of sales on the value of the property. Ultimately, the amount of rent a retailer will pay for a space is related to its ability to generate sales and maintain healthy profit margins.

A drop in sales, an increase in operating costs, or both, may push the cost of occupancy to an unsustainable level. If a retailer has a relatively high occupancy cost ratio compared to market norms, it signifies that the landlord may have to reduce the rent or risk losing the tenant.

To show the assessor the impact of declining sales on property values, retail centers owners should project annual sales per square foot for each tenant and apply the appropriate occupancy-cost ratio to the annual sales figure.

## Illustrating through numbers

Assume that a tenant's sales during the height of the market were \$500 per sq. ft., and now those annual sales figures have dropped to \$350 per sq. ft. An analysis of industry statistics determines that the average market occupancy cost ratio is 8% for this tenant's merchandising category and the type of center.

Applying the 8% occupancy cost ratio to the booming market sales figure of \$500 per sq. ft. indicates that this tenant can be profitable at an occupancy cost of \$40 per sq. ft. To illustrate to the assessor the correctness of an owner's claim concerning her property value, the same 8% occupancy cost ratio must be used. The 8% is multiplied by today's annual sales of \$350 per sq. ft., producing a new sustainable market occupancy cost for this tenant of \$28 per sq. ft., as shown in the accompanying chart.

For the retailer to maintain acceptable profitability margins, the total occupancy costs—rent plus expenses— must be reduced by \$12 per sq. ft. This decrease in sustainable occupancy cost provides support for the determination of market rent, which should be utilized by the assessor to value the property for tax purposes.

Shopping center owners should always ensure that the rent used by the assessor in calculating the center's tax assessment is an amount that allows tenants to operate profitably in whatever the existing market environment may be.



**Darlene Sullivan is a partner with the Austin law firm of Popp, Gray & Hutcheson LLP, the Texas member of the American Property Tax Counsel. She can be reached at [darlene@property-tax.com](mailto:darlene@property-tax.com).**