



The effect of disruptions on sales-based rental models in Hong Kong

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Hong Kong's retail rental market has three distinctive features: rents are usually extremely high, tenancy agreements typically favor landlords, and calculations of rent often contain a sales-based component.

The retail industry is a prominent example of operational real estate in Hong Kong: retail sales were more than 17% of Hong Kong's gross domestic product in 2018¹. Unfortunately, the sector has been a casualty of the protests taking place since June 2019. As you would expect, short, medium and long-term events can all affect sales-based rental models. So what steps can landlords take?

Rental models

Rental of retail space in Hong Kong is usually the higher of a fixed amount, or a combination of a fixed amount and a percentage of sales. The advantage of sales-based or turnover rent for a landlord is that a landlord can benefit from a tenant's strong sales performance. However, if a tenant's sales are poor, the landlord also suffers. A landlord needs to balance its need for certainty of income with its ability to participate in a tenant's success without such a model being overly burdensome to a tenant. On this basis, it's usual for the fixed component of a "combined" rental model to be the vast majority of the rent charged.

Short-term disruption and how landlords respond

Hong Kong retail tenants might suffer from a range of brief interruptions to their businesses. These could include a lack of access to the property for customers because of suspended transport services, construction work, power cuts or even bad weather. Hong Kong is habitually subject to typhoons that cause millions of dollars' worth of damage. In 2018, the clean-up following Typhoon Mangkhut took weeks and insurance claims totaled USD370 million².

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Leases in Hong Kong usually contain rent abatement provisions if the property is rendered unusable or inaccessible due to damage caused by phenomena including fire or flooding. That is generally as far as landlords go: they will not accept further changes to rental provisions due to short-term disruptions.

Medium-term disruption

Civil unrest has been a recurring theme in Hong Kong's recent history, most notably in 2014 and the current protests, which started as demonstrations against a proposed extradition bill in June 2019.

The retail sector has been severely affected. Retail sales plunged 23.6% in November 2019, the biggest monthly drop on record³. Consumer spending dropped to USD3.84 billion that same month after a record 24.4% year-on-year slump in October⁴. The hardest-hit goods are luxury items such as jewelry, watches and valuable gifts, which saw a staggering 46% drop in sales value in November from the previous year⁵. High-end fashion brands reported sales declines of up to 45% in the quarter ending September 30, 2019⁶.

Luxury sales are mainly driven by international travelers, with visitors from China accounting for up to 70% of purchases⁷. Large numbers of shoppers visit from mainland China to take advantage of lower prices: a free port, Hong Kong does not impose customs tariffs on imported goods. As protests have turned more violent and anti-China sentiment increased, they are shunning Hong Kong in favor of destinations like South Korea, Japan, Singapore and Thailand. The number of visitors, mostly Chinese, nosedived more than 50% year-on-year in the first seven days of October, known as the “Golden Week” national holiday⁸.

How landlords are responding

Landlords are taking different approaches to the protests that are disrupting retail sales and so their sales-based rental receipts. Some take an uncompromising approach to rent reductions or cancellations, leaving it to tenants to decide whether they will close for business during protests without the consolation of any rent reductions or cancellations during such periods. High-end fashion companies are notable casualties of this strategy, with one famous luxury brand planning to shut a store in the protest-affected shopping district of Causeway Bay supposedly after its landlord refused a request to lower the rent.

Other landlords are offering rental adjustments to help tenants. One has proactively offered temporary rent reductions of 10-20% to the majority of tenants in a shopping center and promised to offer reductions in August 2020 based on tenant requests⁹. It has also allowed its anchor tenant, which formerly occupied the ground and second floors, to consolidate its sales space exclusively on the second floor¹⁰.

Landlords of some of the largest shopping centers are giving tenants prior notice about mall closures and offering rent reductions or waiving rent for closed days. The landlord of a center that sustained so much damage in 2019 that it remains closed is allowing tenants a rent-free period while repairs continue¹¹.

In addition to loyalty, another possible reason why landlords are reducing rent is that finding new tenants is expensive, time-consuming and can outweigh the medium-term costs of reduced rent. Landlords might also struggle to find new tenants in the current climate.

Long-term disruption and how landlords might respond

The current protests have been in progress for less than a year and it remains unclear how landlords will behave as disruptions to retail sales move from medium to long-term. Real estate services firm JLL believes more landlords will consider adjusting rents amid the current crisis and the sluggish economy, as Hong Kong slipped into its first recession for a decade at the end of 2019¹².

Landlords might also consider changing how rents are calculated, such as by insisting on a higher amount of fixed rent to give themselves more certainty of income. Alternatively, they could accept a lower amount of fixed rent but a higher percentage of sales-based rent subject to that lower monetary threshold. Landlords could also restructure the terms of leases to accept higher rent for a shorter term or lower rent for a longer term.

They may also be forced to reduce their rents in the long term. For example, a well-known fashion brand confirmed it will not renew its lease at its flagship store when it expires in June 2020¹³. The landlord announced it would slash the monthly rent by 44% for its next tenant¹⁴.

Some landlords are already changing their tenant mix to replace luxury boutiques, which rely so much on visitors from China and other countries, with more accessible lifestyle stores and restaurants catering to local customers¹⁵. Landlords might persist with this approach and, given the choice, choose tenants less likely to attract protesters and so minimize disruption and damage to their properties.

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models for retail landlords.”

Landlords are also increasingly filling vacant space by letting to pop-up shops. The lease term can run from seven days to six months, so providing landlords with greater flexibility¹⁶. Although the rent paid is typically 20-30% of normal rates¹⁷, this trend may continue if landlords struggle to secure longer-term tenants. In conclusion, the protests in Hong Kong demonstrate both the advantages and potential vulnerabilities of variable sales-based rental models for retail landlords. Landlords need to carefully monitor disruptions and consider the range of potential solutions available to protect their long-term interests.

¹<http://hong-kong-economy-research.hktdc.com/business-news/article/Market-Environment/Economic-and-Trade-Information-on-Hong-Kong/etihk/en/1/1X000000/1X09OVUL.htm>

²<https://insuranceasianews.com/typhoon-mangkhut-hong-kongs-claims-breakdown/>

³<https://www.scmp.com/business/article/3044553/louis-vuitton-paid-estimated-hk5-million-monthly-rent-times-square-its>

⁴<https://www.scmp.com/news/hong-kong/hong-kong-economy/article/3044540/hong-kong-protests-continue-batter-retail-sector>

⁵Ibid.

⁶<https://www.scmp.com/lifestyle/fashion-beauty/article/3044433/top-luxury-brand-plans-close-protest-hit-hong-kong-store>

⁷Ibid.

⁸<https://www.scmp.com/news/hong-kong/hong-kong-economy/article/3032562/mtr-corp-and-airport-authority-plan-offer-rent>

⁹<https://hk.finance.appledaily.com/finance/20200108/C43U2Z36HHWWO7FRDWTIJ2IR3Y/>

¹⁰<https://www.scmp.com/lifestyle/fashion-beauty/article/3038400/chanel-rimowa-delay-new-stores-prada-moving-out-sales>

¹¹<https://hk.finance.appledaily.com/finance/20200108/C43U2Z36HHWWO7FRDWTIJ2IR3Y/>

¹²<https://www.scmp.com/lifestyle/fashion-beauty/article/3038400/chanel-rimowa-delay-new-stores-prada-moving-out-sales>

¹³<https://www.scmp.com/business/article/3023267/causeway-bay-retail-landlord-offers-cut-rent-44-cent-prada-closes-flagship>

¹⁴Ibid.

¹⁵<https://www.scmp.com/lifestyle/fashion-beauty/article/3038400/chanel-rimowa-delay-new-stores-prada-moving-out-sales>

¹⁶<https://www.scmp.com/property/hong-kong-china/article/3045829/luxury-brands-use-pop-stores-skirt-hong-kongs-sky-high>

¹⁷Ibid.