

RETAIL CEO PAY: A “VIRTUE-LESS CIRCLE”?

A Durler Consulting study

January 2009

What a difference 6 months make

Current market conditions are creating extremely challenging conditions throughout the UK retail sector, although retail trading is equally challenging in most major economies around the world. Trading statements for the Christmas period codify the difficulties. Kingfisher, DSG international, KESA, Home Retail Group and many others have recorded negative like for like sales, in some cases in double figures. Evidence suggests that the post-Christmas period saw a slightly better performance for some retailers, but most analysts seem to concur that this was a last hurrah for bargain hunters, likely to be followed by a period of intense belt tightening. The only parts of the retail sector that continue to perform even reasonably well are supermarkets. Indeed, the post-Christmas trading statement from Sainsbury's indicates that the retailer had its best ever Christmas performance as its promotional shift to value brands caught the mood of the consumer.

In recent months, the shape of the UK retail landscape has undergone more change than it has experienced in living memory. Woolworths, MFI and others have either closed or found themselves in administration. In the case of Woolworths, retail space equivalent to several High Streets now lies unfilled. More retail casualties are undoubtedly imminent and the retail landscape in the UK will look different again in another six months time. Adams, Whittard's and Zavvi have gone and widespread consumer anxieties are impacting the performance of others. Recent trading updates from Kingfisher PLC, owner of B&Q, and DSG international PLC, owner of Currys and PC World, provide further confirmation of the steep decline in consumer confidence, with DSGi reporting its first H1 loss in more than two decades and a 10% deterioration in like for like sales for the Christmas period.

The demise of Woolworths and MFI are both notable. The consensus appears to be that in the case of Woolworths, the business has defied gravity for years and senior management had for too long mistaken nostalgia for a brand and in the case of MFI the business has been hamstrung by possibly outmoded but nonetheless deeply embedded brand perceptions. We make no value judgement about management decisions in relation to these two businesses; however, their demise is emblematic of the core requirement of executives in retail – that they maintain an unwavering focus on the medium-long term trajectory of their business and avoid the seductive allure of getting too deeply entrenched in day to day trading issues.

Returning to the matter of recent business performance, online retailing is bucking the bricks and mortar trend and continues to show overall level of growth, although this is still on a low base and growth rates are beginning to slow. The most recently reported year on year increase in UK online sales is 30% which contrasts with growth figures of more than 100% year on year as recently as a year ago. But even for online sales there is conflicting evidence, with some forecasting bodies predicting an unprecedented decline.

Share price movements in the sector have also been dramatic, with some retailers losing more than 80% of their stockmarket value in the last 12 months. It is brave analyst who would call the bottom of the market, and it is inevitable that 2009 will be a very difficult time for the retail sector. There is, though, a sense that selling of some stocks has been overdone, resulting, if evidence were needed, in some of the most trenchantly negative analyst positions on some stocks edging gently towards a more positive outlook.

Pressures from every direction

A multitude of issues are affecting the retail sector: Consumer debt, fears of unemployment, a weakening pound that is making imported goods more expensive for consumers, lower-cost web operators, bank collapses, a lack of available credit and more. Many household names face intense pressure and the normal orderly progression towards Christmas has been thrown into disarray with retailers launching promotions and sales, utilising tactics that are not normally associated with this time of year.

For most retailers, the lead up to Christmas and the January sale period generate more than 50% or annual profits. The expectation at this juncture, even taking into account the recently announced fiscal stimuli, is that a significant number of retailers will face a difficult start to the New Year as they seek to shift stock, levels of which are based on commitments made in more benign economic conditions earlier in 2008.

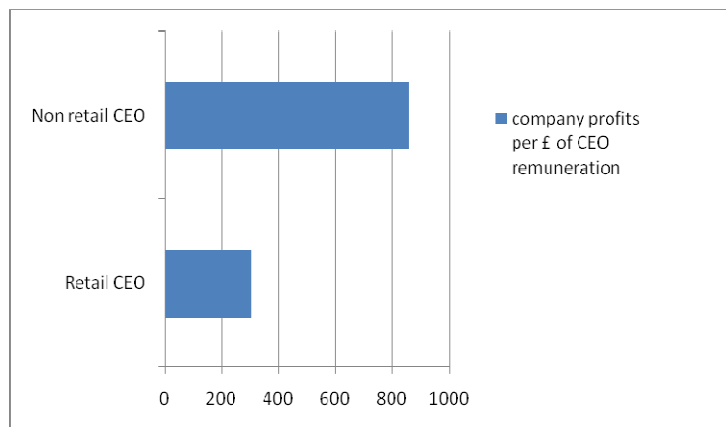
The challenge for leadership teams in retail organisations in this context is that now more than ever businesses are faced with the need for relentless tactical execution. Senior executives, including most

importantly the chief executive, who ought to be focused on medium-long term strategy, are increasingly drawn in to day to day trading issues to try and stay one step ahead of the competition. This relentless tactical execution, whilst essential for business survival in difficult times, is proving to be too much of a preoccupation for CEOs according to the recent soundings that we have taken from leading retail industry executives and observers.

Do or die pay deals

This comes against the backdrop of several years during which retail board remuneration committees have been awarding their CEOs “do or die” pay deals that are in many cases out of step with industry averages, according to our analysis.

Our study finds that retail boards have been agreeing disproportionately high salaries and bonuses for CEOs to immunise them against career risk, whilst at the same time average length of tenure is falling. It would appear that the immunisation may well be tested if retail performance does not improve in the next twelve months. For now, with some



exceptions, boards and shareholders will want to give CEOs the benefit of the doubt. The line will be similar to that pursued by governments, i.e., that current trading conditions reflect worldwide issues and the blame cannot be laid at the threshold of my store. But that position will increasingly be tested as the months go by. Shareholders may be prepared to sacrifice a dividend in the short term, but any business that shows signs of on-going malaise may well find itself with a new CEO, especially those retailers that display bellwether characteristics. Any suggestion that they are off the pace when recovery comes will be greeted mercilessly.

The numbers make the case for the pressure that retail CEOs will inevitably face. Based on an analysis of aggregate data from the most recent annual reports from UK-listed retailers, the typical retail CEO earns £1 for every £305 in profit versus £1 for every £858 on a cross-industry average. The average

retail CEO has seen his/her pay packet increase 38% in the last five years. These figures, of course, are based on business performance that pre-dates the current dramatic slump. A reasonable assumption is that retail CEO reward will be even more out of step with cross-industry averages as the next round of results are issued.

It would appear that CEOs are aware of the growing disconnect between reward and shareholder return. As Robert Peston, the BBC's business editor, wrote on his blog on January 7th:

"What should happen to business leaders' remuneration in this downturn?"

Well Sir Stuart Rose, the chairman of Marks & Spencer, was characteristically blunt when I interviewed him earlier today.

"I certainly won't be taking a pay rise" he told me. "It would be inappropriate for me to do so...I am 99.99% certain there won't be a bonus. I certainly won't be getting anything over and above what my staff will enjoy."

As for the example that should be set by Britain's executive class in general, Rose said there must be absolutely "no payments for failure."

Which most of you may well say is common sense, at a time when almost every company tells me that it's either reducing job numbers or is about to do so.

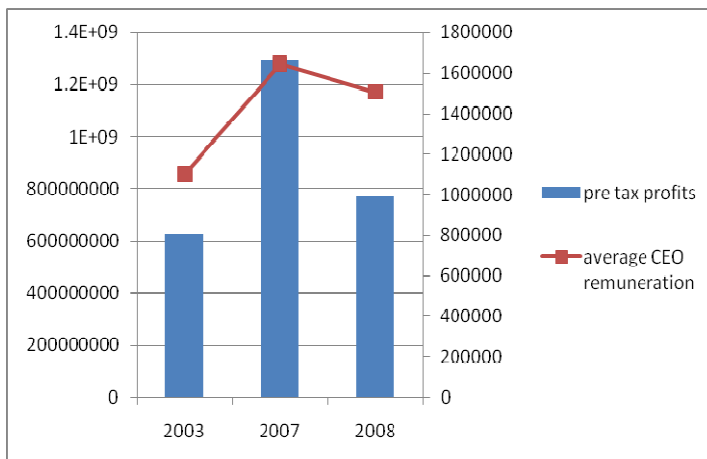
But as we've seen over many years, common sense doesn't always rule in the board room when remuneration is being decided."

The virtue-less circle

In our view, there will be a correction in CEO rewards as the economy climbs out of the current downturn. In recent years retail boards have been agreeing pay deals for new CEOs that have factored in an assumption that their appointee will not be in post for long. Performance pressures were mounting inexorably in the retail sector even before this dramatic slump in what our industry sources have been collectively describing as a "virtue-less" circle in which CEOs, under intense pressure to deliver, are involving themselves in tactical trading decisions at the cost of medium to long term strategy and at the same time demanding more to insulate themselves against the risk of underperformance. CEOs now find themselves working between the teeth of a crusher, with shareholders and analysts on one side and trading and the downturn on the other.

Inevitably these extremes of performance pressure, especially in current market conditions, make it more difficult for a CEO to look beyond driving business performance in the short term (aka this weekend's sales), creating a gulf where strategic leadership ought to reside. The net effect is an increased risk of a spiral of underperformance – and a very real danger that measures will not be taken to position the business favourably for the inevitable recovery.

The pay to profit ratio



To put this in context, retail CEOs earn an average of £1,523,821 per annum including salary and bonuses. The attractive salary packages negotiated by CEOs have helped to double executive earnings capacity in the past 12 months. In 2007, retail executives were earning 0.001p for every pound of profit. Today they earn 0.002p. FTSE250 retail executives earn £1 for every £117 of

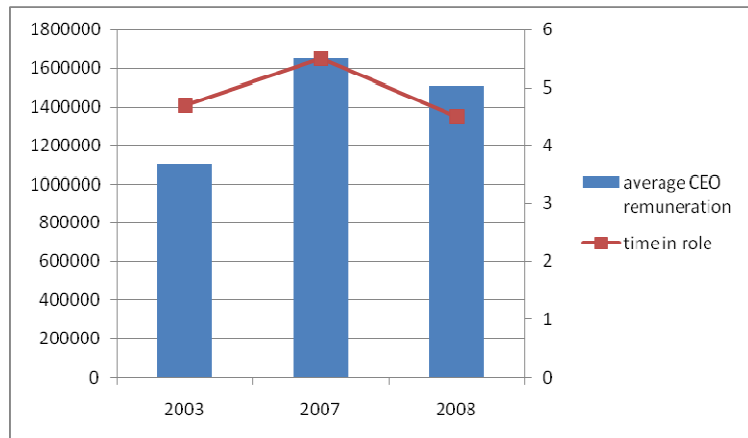
profit delivered whereas FTSE100 retailers earn £1 for every £467.

One contributory factor to the current situation has been the slide in the value of many previously pre-eminent retail stocks as the analyst community marked down the value of many household names and many left the FTSE100. The net effect was that mid-market retailers, anxious to get their businesses back into the premier league, offered particularly attractive salary and bonus packages to their executives, in part because they need to pay what the market will bear, but also because these CEOs are expected to deliver major business turnarounds. Executives such as Steve Johnson at Woolworths, John Browett at DSG international, and now Thierry Falque-Pierrotin at Kesa were brought in as miracle workers, and paid as such. With all due respect to Mr Johnson who hardly had time to familiarise himself with the business, clearly Woolworths was not the place where miracles are made.

Age, gender and tenure: “young men in a hurry”

Despite the welcome arrival of first class women retailers in the last ten years, Jacqueline Gold and Kate Swann amongst them, the job of retail CEO is still largely the domain of men.

As well as being better paid than their peers, retail executives are younger, at an average age of 49 (FTSE average 50) although they do spend longer in post, at an average 5.4 years in 2008 (FTSE average 4.5 years.) In general, CEO tenure is dropping, from 5 years in 2003



to 4.5 years today – arguably dropping below the term needed to plan and deliver a medium-term turnaround strategy. This marks a break from the past. For decades, retail in the UK was dominated by long-serving CEOs and chairmen, including the formidable Lord Kalms, Sir Geoff Mulcahey, Sir Ken Morrison and many others.

Cautious predictions

Looking at the likely scenarios in the year ahead, we make the following predictions, with the caveat that truth can be stranger than fiction in the current market:

- **Likely consolidation in the sector** as weaker retailers seek strategic partners or are acquired. This, along with bankruptcies, leads to a potential glut of middle to senior management talent on the market. It will be a good time to recruit and reorganise for businesses that see a way through the current gloom and wish to position themselves to capitalise on the eventual upturn.
- **A buoyant market for executives with dotcom experience**, as bricks and mortar retailers find that their low cost base rivals are stealing their lunch and those with a multi-channel offering seek to expand their online operations. According to The State of Retailing Online 2008, the 11th annual Shop.org study conducted by Forrester Research, 72% of online retailers believe that the online channel is better suited to withstand an economic slowdown than offline channels. Recent sales

numbers from the British Retail Consortium show that online shopping is the only consistent growth sector.

- Greater focus on **recruitment of executives with turnaround competencies** as businesses reel in the face of falling sales. For some Boards, there will be hedging of bets about the likely scenarios. We anticipate that some businesses will develop unofficial succession plans as a means of guarding against the unexpected.
- **A greater focus on acquiring talent from the sectoral businesses that may fare better** in a downturn. Budget food retailers and low cost fashion operators in particular are expected to take advantage of uncertainty to coax key talent into their businesses. The verso is also the case, of course, and we suspect that retailers that are relatively immune from the downturn will be cherry picked for operational talent.
- **A relatively stable period in the short term for CEO tenure** until market conditions stabilise and businesses have a clearer view of industry comparators. Executive recruitment is likely to be driven by the acquisition of functional talent to deal with specific operational, route to market, supply chain and purchasing issues. We do expect, though, that CEO pay in the retail sector will be scrutinised more closely than at any time in modern corporate memory, as will its relationship with business performance. We believe that an overdue adjustment is likely to take place and that there will be a flattening of the reward graph across the senior management team in most retail organisations.

Our research: The Durler Consulting study evaluated retail companies in the FTSE250 against a randomly selected sample of non-retail organisations. CEO age, tenure and remuneration, and company pre tax profits for 2008, 2007 and 2003 were compared.