Rewarding the Board:

How does the retail industry compare?

BDO Stoy Hayward

Highlights

- CEOs in the retail sector typically earn higher salaries than other sectors.
- The average tenure for a CEO of a retail business has increased by 30 per cent in the past five years.
- In 2007 one third of retailers did not pay their CEO a bonus.
- The base pay for FDs is generally around 70 per cent of the CEO.
- Unlike other sectors, retailers are not asking executives to defer part of their bonus into shares.
- The challenge is to set fixed pay at the appropriate level and design performance-linked pay to generate growth.

“CEOs and FDs in the retail industry are paid up to 68 per cent more than in other industries”

Introduction

Guiding retail businesses through the harsh environment that is the UK High Street is no enviable task for chief executives and finance directors in today's turbulent economy.

Battling for the consumer's ever decreasing disposable income in the face of rising costs across the board, slashing prices on an eye watering scale to drive sales and trying to manage the impact of the unpredictable British weather are just some of the current headaches for those in the retail front line.

In a recent study, BDO Stoy Hayward has conducted research looking into the make-up of pay for chief executives and finance directors in quoted companies in the general retail sector. The report looks at three key components of remuneration: base pay, bonuses and long-term incentives.

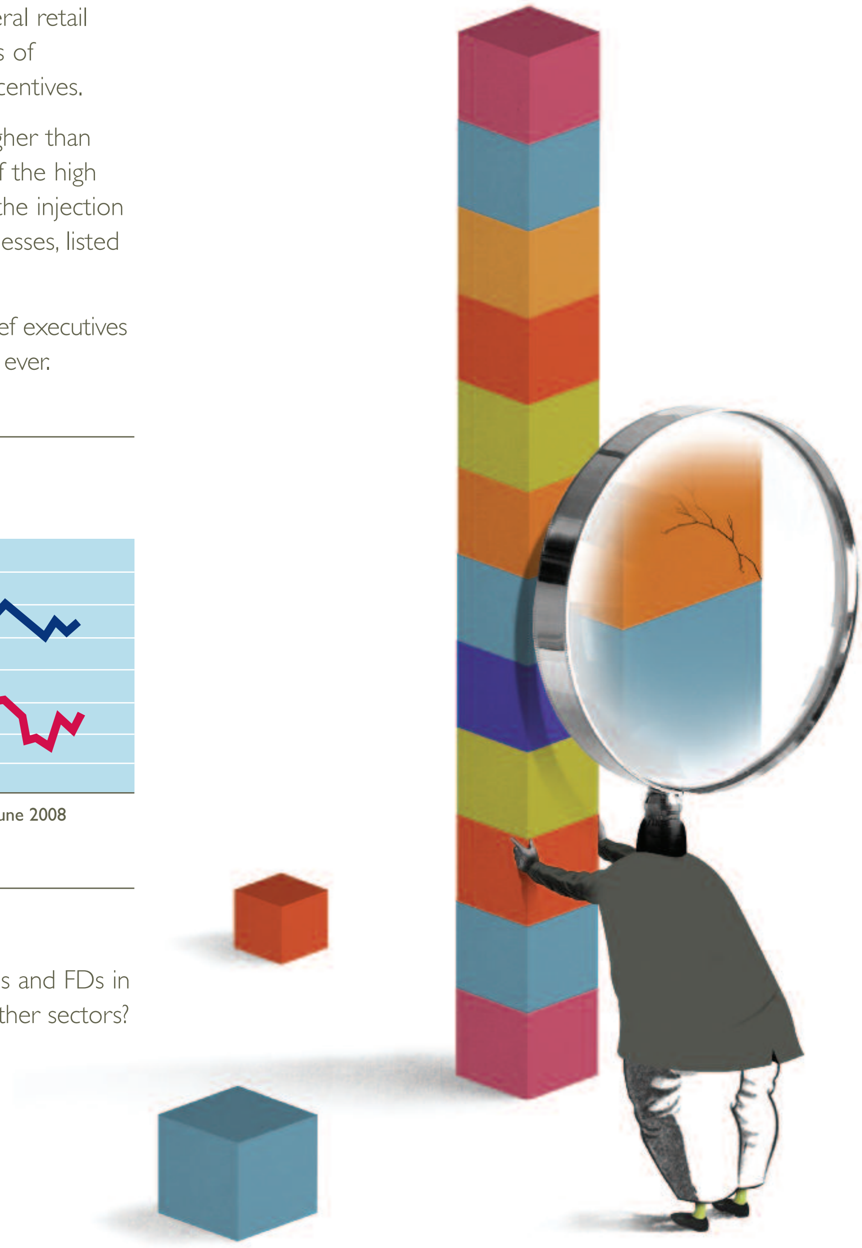
As this report shows, CEO base pay in retail is higher than that of other sectors. This is possibly as a result of the high profile nature of the industry. Furthermore, with the injection of private equity investment into many retail businesses, listed retailers have had to respond accordingly.

With falling share price performance (as below), chief executives and finance directors are in the spotlight more than ever.

Share price performance chart
FTSE all-share vs general retail sector

Source: London Stock Exchange

What does this mean for executive pay? Are CEOs and FDs in retail businesses paid more or less than those in other sectors?



Current issues

Understandably, the changing climate means that demanding performance targets are set at lower levels than in previous years. Some of the biggest companies (Next and Marks & Spencer have been quoted in the press) have reacted by reducing the performance required in order for this year's long-term incentive awards to vest.

Some existing plans are not paying out. Next's innovative spread bet on the future share price is not likely to pay out. Investors may see this as fair but it is still important to have effective incentives to revive retail fortunes.

Executives often expect a certain level of earnings and some companies have been paying one-off 'retention' bonuses to executives who threatened to leave. Risk Metrics, the monitoring group that provides corporate governance guidelines to the NAPF and other institutional investors has highlighted this as a problem, as such payments do not need shareholders' approval and only appear in the directors' remuneration report after the event. Therefore, managing the communication process with shareholders is increasingly important. Shareholders need to understand the business imperative behind such bonuses. Structuring bonuses, perhaps with part deferred into shares, may assist with this dialogue.

No-one objects to pay for performance. Problems arise with 'reward for failure.' The Combined Code tells remuneration committees that performance related elements of remuneration should form a significant proportion of the total remuneration package of executive directors and should be designed to align their interests with those of shareholders and to give these directors keen incentives to perform at the highest levels. Given the number of directors not receiving bonuses at present, it appears that this is happening.

This obviously raises the question of what shareholders want from your company. With at least a dozen high-profile retailers having gone into administration already this year, survival could be the first task. Sometimes, selling the company for an acceptable price meets shareholders' objectives, while at other times, it is important to retain the company's independence so that shareholders can benefit from the recovery when it comes.

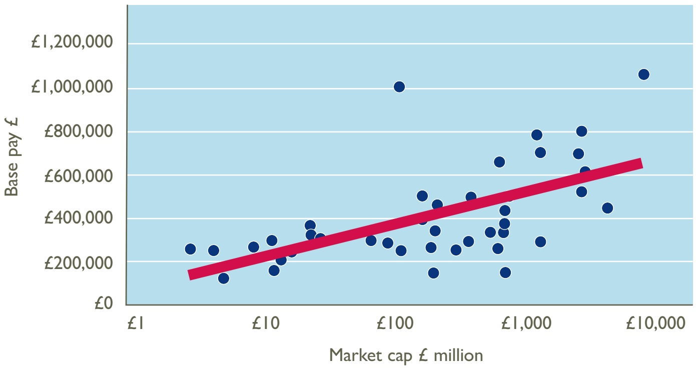
Defining success and failure and agreeing the definitions with shareholders can lead to realistic but challenging performance targets being built into long-term incentives in an acceptable manner. The majority of the retailers surveyed still have earnings and/or total shareholder return targets, but we are seeing some more specific targets, such as HMV's targets for increasing sales via the internet.

Chief Executives

Base pay

In general, base pay is largely a function of the size of the company. As a result, within the retail sector FTSE 100 directors will earn more than those within the Small Cap Index, but there is a lot of variation round the trend line.

CEO base pay in the general retail sector



Having said that, on the whole, CEOs of the 43 quoted companies in the sector had relatively high base salaries:

CEO base pay	General Retail	All sectors
Upper quartile	£503,500	£320,000
Median	£332,000	£255,000
Lower quartile	£261,500	£190,000

One reason for this could be historical. Share prices fluctuate but fixed pay, ie salaries, do not. So, where there is a downturn and the share price has fallen dramatically, the CEO would not take a cut in base salary but total pay will fall as a result of lower bonuses and the fact that long-term incentive plans (LTIPs) will probably not vest.

BDO Stoy Hayward's research suggests that CEOs in the retail sector remain in post for a relatively long period and as a result will probably see at least one economic cycle.

The average tenure for a chief executive of a retail business has increased by 30 per cent in the past five years. During this time there has been a significant amount of corporate activity, much of it including private equity with secondary and even tertiary buy-outs. Despite, or maybe because of, this activity and the influence of private equity players, it has, in the main, been a successful time and arguably this has been key to management teams remaining largely unchanged.

However, a year on from the start of turbulent times in the UK economy it will be interesting to see how stability in these high profile roles is affected in the coming years. CEOs will be forced to take centre stage as they seek to maintain a course and guide a retail business through uncharted and challenging waters.

Bonuses

Bonuses are meant to reflect performance over the preceding year. However, as they are often designed to pay out a percentage of salary, salary level remains a key factor. It is interesting to note that in 2007, one third of retailers did not pay bonuses to their chief executives. However, CEOs with the highest bonuses also received more than their peers in other sectors.

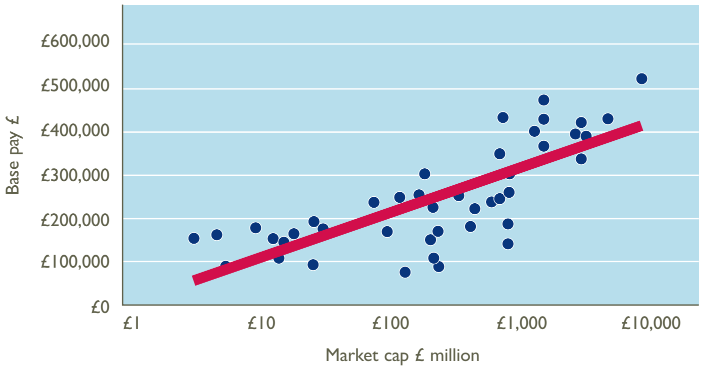
The following table shows bonuses actually paid. Bonus opportunity, the headline figure, is much higher, but it is rare for a chief executive with a bonus opportunity of, say, 100 per cent of base pay actually to receive the maximum.

CEO bonuses	General Retail	All sectors
Upper quartile	£338,000	£200,000
Median	£71,760	£102,000
Lower quartile	£0	£6,000

Finance Directors

The picture is similar for finance directors, although their base pay is generally around 70 per cent of that of chief executives.

FD base pay in the general retail sector



FD base pay	Retail	All sectors
Upper quartile	£353,500	£210,000
Median	£236,000	£175,000
Lower quartile	£165,000	£140,000

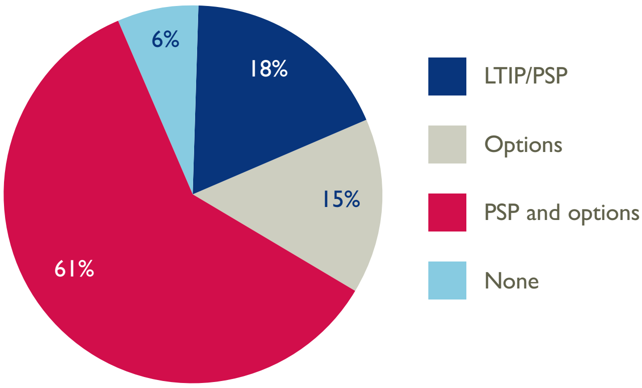
FD bonus	Retail	All sectors
Upper quartile	£181.000	£116,000
Median	£23,000	£62,000
Lower quartile	£0	£15,000

It is interesting to note that, although on the whole, finance directors in these companies earn approximately 70 per cent as much as their chief executives, the gap is much greater in the companies with the highest paid chief executives. There is less variation from the trend line and while pay is higher in bigger companies, the rate of increase is less than for chief executives. Having said that, a finance director in a FTSE350 company will still expect to earn three times as much as a finance director in a fledgling company. Of the 18 companies that did not pay bonuses to their chief executives, five did pay bonuses to the finance directors.

Long-term incentives

Many companies abandoned share options for performance share plans (PSPs) or other types of long-term incentive plans (LTIPs) that paid out the whole value of the shares, not just the growth. It is interesting to see that a high proportion of companies in the sector awarded both options and PSPs. A combination can provide a more balanced remuneration package. In a falling market, a major advantage of PSPs is that an executive can obtain a benefit if the company meets its performance targets. With share options, the company can meet its targets, but if the options are under water, there is no benefit to the employee.

Types of share plan



The most recent trend has been for companies to require executives to defer part of their bonus into shares. In return they provide matching shares after three years if performance targets are met. Few retailers currently operate such a plan.

In a volatile sector, the challenge is to set fixed pay at the appropriate level and design performance-linked pay to generate growth. Designing performance targets to reward real and comparative performance is important. Equally important is articulating strategy to shareholders if the remuneration committee is to avoid awkward questions at the AGM.

How can we help you?

As we come to the time of year when the remuneration committee will be reviewing executive directors' pay for the coming year, you should be looking at the following:

- What is your company's overall reward strategy for the executive directors?
- What is an appropriate balance between fixed and variable pay?
- Does your company need to review base pay levels and bonus potential?
- Are your long-term incentive plans really providing an incentive to generate growth?
- Have you got under water options? If so, what should you be doing about them?
- How will shareholders react to change? How will they react if you do nothing?

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We provide advisory, transaction and assurance services and our partners are renowned for their commercial and pragmatic approach to solving problems. BDO Stoy Hayward's Reward Team works with remuneration committees and executive directors to design, benchmark and implement all elements of directors' remuneration.

We address the issues that matter to our clients by providing fresh thinking, constructive challenge, and a flexible approach. We achieve this through combining detailed sector knowledge with market expertise and international reach.

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