

ARE RETAIL BOARDS EQUIPPED TO MANAGE THEIR PROPERTY AND LOGISTICS EXPOSURE?

FIDELIO OVERTURE



STRATEGY & THE SKILL MATRIX

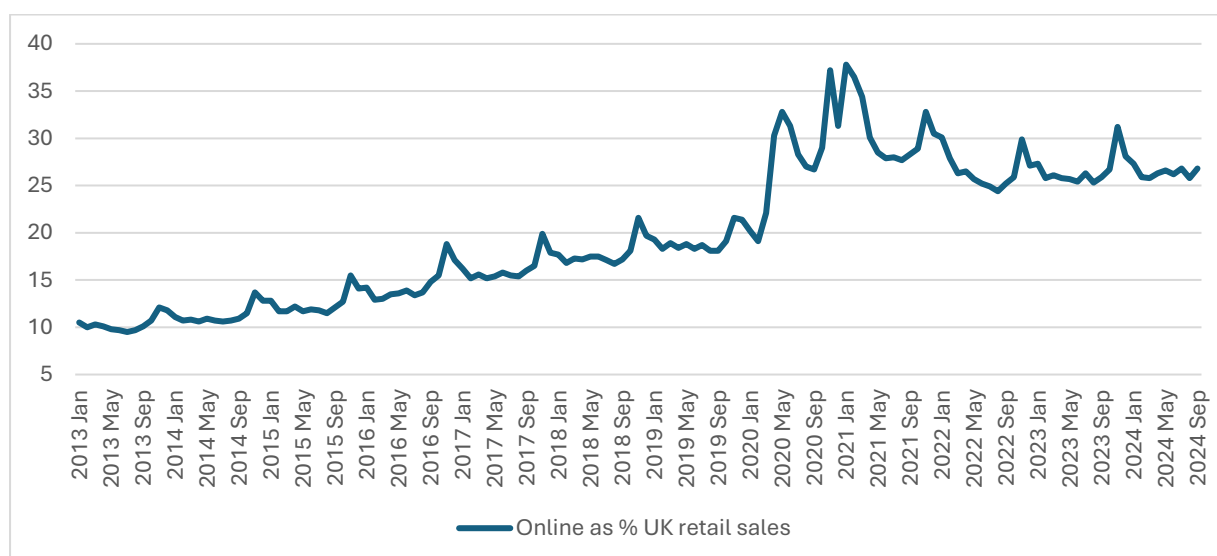
UK & EUROPEAN BOARD COMPOSITION

In this Overture, we examine whether UK and European retailers' Boards have the skills to lead and support company strategy in a fast-changing environment for property and logistics assets.

With retail property having been in a downturn for the past decade, most retailers have been reducing their financial exposure by selling assets, conducting sale and leaseback deals, renegotiating rental terms and reducing lease length. This seemed like a sensible strategy due to ever-increasing online penetration, with stores closed for much of 2020 and 2021 and the threat of higher interest rates. As a result, most retailers have achieved considerable savings in rental costs and a reduction in lease liabilities over the past five years, making store parks fit for purpose. Where they have invested in property, it has largely been in logistics assets.

CHALLENGING ASSUMPTIONS

However, it is time to question some of the assumptions that underpinned these decisions, i.e. increasing e-com share, falling rentals and capital values and higher interest rates:

TABLE 1: ECOM PENETRATION SEEMS TO HAVE STALLED EARLIER THAN EXPECTED

Source: ONS

Following the explosion of eCom demand during COVID there was a thought that we had entered a structurally higher level of penetration as late-adopters finally embraced the internet. In practice the opposite seems to have happened and eCom penetration fell back to pre-Covid levels and now seems to have levelled off. In part this may have been caused by leading multi-channel retailers finally weaning themselves off un-economic practices such as free returns, and in some cases free delivery. In addition, the gradual return to the office and buoyant tourism have also helped breathe life into city centre commerce.

RETAIL RENTALS ARE STARTING TO RECOVER

The shift of customer traffic back to stores has been reflected in retail rentals starting to increase across most retail categories, while yields are starting to fall and capital values are also recovering. Prime London retail yields compressed by 50bp in 2Q as did Retail Parks (CBRE). High Street and Shopping Centres are broadly flat as they have been since 2022.

PROPERTY M&A IS RETURNING

On the corporate side, there are finally signs of transactions speeding up. On the logistics front there has been a bidding war between Brookfield and Segro for Tritax Eurobox, while London Metric property has been active. L. Catterton recently injected £600m in Hammerson's Value Retail, owner of Bicester Village and 8 other Luxury sites on Europe. Meanwhile Hammerson and Landsec have repurchased stakes in Westquay and Bluewater from GIC.

MANY PARENT COMPANIES HAVE CONTINUED TO RE-INVEST IN PROPERTY

While retailers have generally been divesting their property, the family or majority shareholder behind some notable retailers have continued to re-invest their dividends in

retail and logistics assets, notably Inditex (Ortega family), H&M (Persson), B&M (Arora) and Dunelm (Adderley), some of which are leased back to the operating companies.

LOGISTICS HAS BEEN A CONSISTENT FEATURE OF CAPEX PLANS

The increasing demands of multi-channel retailing and, in some cases, Brexit, has also led to a surge in investment in logistics facilities and the IT platforms to operate them. Capex on logistics has been a significant feature of many retailers' capital plans over recent years.

DESPITE THE DISINVESTMENT, PROPERTY EXPOSURE & EXECUTION REMAIN CRITICAL DECISIONS

As we mentioned, retailers have been managing down their retail exposure, and particularly on-balance sheet IFRS 16 lease liabilities, through shorter and more flexible/turnover-based leases. Nevertheless, occupancy costs typically represent one third of opex or 10-15% of turnover, and lease liabilities remains one of the biggest line items on most balance sheet. In many cases leases represent >100% of shareholders' funds.

3 years post COVID the balance sheets of most of the larger listed retailers balance sheets are now quite strong, and many are buying back shares as part of their capital allocation strategies. If a retailer is well capitalised and expects to occupy a key site for the foreseeable future, then why lease it from a landlord which probably has a higher cost of capital?

In short, given changing assumptions around internet penetration, interest rates, property yields and availability of prime sites, retailers are going to have to make some key decisions in the years to come.

ARE BOARDS EQUIPPED TO MANAGE THEIR PROPERTY & LOGISTICS EXPOSURE?

So having established how important property is to most retailers, we thought it was appropriate to consider how Boards are equipped to oversee this key strategic issue. In the table below we looked at the Board composition for 19 leading UK and European retailers and brands, which we have anonymised.

Unsurprisingly, there is plenty of retail experience on most Boards, both the current executives who sit on the Board, as well as the Chair in some cases. In addition, a number of Non-Executives may also bring complementary retail experience of other markets or business models or business transitions.

The big change over the past decade has been to address Boards' capability in various aspects of Technology/multi-channel brands and retailing, as well as ESG and Finance, with significantly improved diversity and governance.

However, it is clear many retailers have no one on the Board with direct property experience, and even fewer have direct logistics experience.

TABLE 2: ANALYSIS OF BOARD COMPOSITION FOR LARGE UK/EUROPEAN RETAILERS

UK	TOTAL BOARD MEMBERS	BOARD EXECUTIVES	RETAIL EXPERIENCE	LOGISTICS EXPERIENCE	PROPERTY EXPERIENCE
	8	2	6	1	0
	10	2	4	1	0
	12	5	5	1	2
	7	2	2	1	0
	11	4	10	1	0
	9	4	6	0	0
	12	2	10	0	0
	10	4	8	0	1
	10	2	5	0	2
	11	2	5	1	1
	9	2	4	0	1
	11	2	7	0	0
	6	2	5	0	0
NON UK					
	15	0	8	0	0
	10	1	5	0	1
	7	0	3	0	0
	16	0	4	0	0
	15	1	5	0	3
	10	0	3	0	0

Source: Fidelio Partners

SUMMARY

PROPERTY & LOGISTICS CONCERN OPERATIONS, STRATEGY AND ASSET ALLOCATION

We are not arguing that these companies lack operational experience in property. There is usually a head of property at an Exco level. On Boards, one could also argue that many of those with longstanding retail experience will have had plenty of experience working on property-related issues. However, the operating experience of the retailers on the Board will presumably have been operational rather than on a strategic basis, and some time off.

The same goes for logistics platforms which have also become an increasingly strategic asset for retailers, and as with property, there is very little logistics expertise on the Board.

Our point is that property and logistics involve many of the biggest decisions that a company makes around asset allocation, strategy and operations, and the current composition of most Boards does not appear to reflect that. The gradual disinvestment of most retailers from retail property over the past decade, has been consensual across the sector, and has probably been the correct strategy for most. However, times are changing and Boards need to be certain they are structured appropriately.

Please contact Simon Irwin if you would like to discuss the content of this Overture further.

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