

Retailers: why their ESG is important to investors

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Insights



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Environmental, Social, Corporate Governance (ESG) research can be used to identify mispriced stocks, notes Senior ESG research analyst Måns Carlsson-Sweeny. He outlines key ESG drivers in the retail sector and how analysis of these leads to better informed investment decisions and highlights a number of emerging investment risks in the retail sector.

Using ESG to find mispriced stocks

We divide companies into 'investment grade' or 'not investment grade' based on their environmental, social and governance (ESG) profiles. Based on this proprietary analysis, the average relative total shareholder return (TSR) for Australian and New Zealand retail stocks that are investment grade has outperformed that of stocks that are non investment grade in both the short and the long-term. The difference in average relative TSR for investment grade stocks versus non investment grade stocks over five years is 47%.

The ESG profiles are results of detailed analysis of sustainability drivers at an industry level and intangible drivers at the company level.

Research shows that for the typical listed company, the majority of value comes from so-called intangible drivers. For retailers, some of the key intangible drivers include corporate governance, staff engagement, technology and innovation, customer satisfaction, occupational health and safety and supply chain management. In other words, these drivers represent a wide range of information that you don't necessarily find in traditional financial reporting or in traditional broker research.

While there might be relatively weak links between individual intangible drivers and short-term earnings or share price performance for retailers compared to other sectors, a retailer's overall ESG performance can be a good proxy for management quality.

In addition, ESG analysis can detect investment risks before they blow-up and identify cases where current business models are not sustainable in the long-term.

More structural changes than ever: adaptation and innovation are key - but many are playing 'catch-up'

Retailers are under more structural change than ever. Technology change, changing consumer behaviour and preferences as well as globalisation are underpinning a number of trends affecting Australian and New Zealand retailers.

Examples include more competition from online and international retailers, driving price harmonisation and risk of downward pressure on commoditised goods, media fragmentation, which means retailers need to re-think their advertising strategies and the risk of wholesalers moving online.

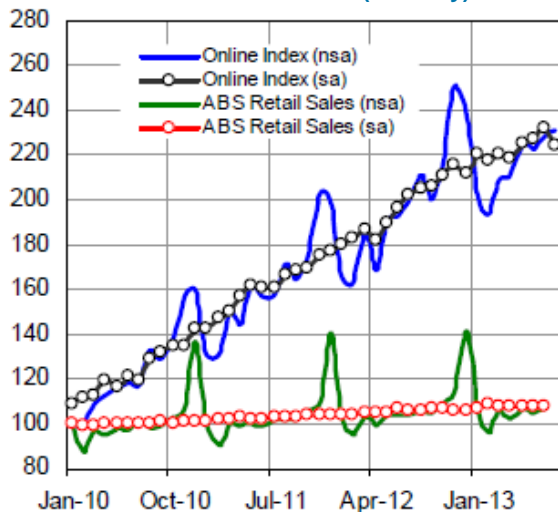
Combined, these changes highlight the need for retailers to understand their customers better and adapt to the new environment with greater emphasis on technology and innovation. In some cases, the structural changes also represent opportunities, such as selling to new offshore markets although building brand awareness online can be an expensive exercise.

Evolution favours those that are able to adapt. Properly used, technology can increase interaction with consumers, improve customer experience, create operational efficiencies and boost sales.

However, on the whole, Australian retailers have been too defensive and too risk averse, which shows in the lack of innovation and under investment. As a result, many are now playing catch up. While focus on technology and innovation is no guarantee for success, lagging behind can be recipe for failure.

Some retailers waited very long before they embarked on omni-channel strategies, which means they now face execution risk and potential margin dilution in the short term.

Online sales versus retail sales (monthly)



Source: <http://business.nab.com.au/online-retail-sales-index-monthly-update-august-2013-4701/>

Most listed retailers now have transactional websites (although exceptions still exist and some might still be missing out on sales opportunities), but online sales mostly account for 1-2% of sales.

In contrast, consider how Pumpkin Patch in New Zealand built on its experience in catalogue sales and its online revenue is currently above 10%. Flight Centre is another interesting example in terms of innovation and adaptation. Its blended travel strategy enables customers to switch between sales channels (e.g. online and in-store), which can give it a competitive advantage in the travel sector.

Key points from *Making the Web the Centrepiece of a Retail Organisation* (by ARA and NetSuite), July 2013¹:

- > Online retail spend is expected to reach more than \$18bn in 2013 and to grow by 39% to \$25bn by 2015
- > Over 50% of Australia's 77,000 retail businesses have a website, but only 1/3 currently transacts online
- > An estimated 33-50% of online expenditure by Australian shoppers are going to overseas sites

Many Australian and New Zealand retailers have lagged international peers when it comes to capturing and capitalising on customer insights. Some retailers have the right assets, but the value does not lie in the data but in how a company capitalises on the data.

However, there are those that adapted relatively early. For instance, Specialty Fashion Group now has a large customer database with over 4.5 million active members who account for approximately 80% of sales. The company can track customers through the omni-channel journey, capitalise on customer insights and use it for direct marketing. Interestingly, the company's omni-channel customers spend considerably more than their single-channel customers.

Another interesting example of innovation is Super Retail Group's loyalty program, which gives more incentives for customers to swipe their cards in store and a better opportunity for the company to capture customer insight. An interesting feature of this program is that customers who

¹ <http://www.powerretail.com.au/news/australian-retail-lags-2013/#ixzz2ig7eW99T>

bought at full price can come back and get credit for the price difference if the product goes on sale. What the company might lose on the price difference can be offset by additional sales and store traffic. Another interesting case in point is Myer, which spent approximately \$50 million in rewards gift cards to its MyerOne members in FY12, but the average customers spend many times the value of the rewards when redeeming.

Capturing and capitalising on customer data is not without risk though. Current privacy laws might be inadequate when it comes to dealing with re-identification from major data. This could become a brand and legal risk, particularly if the data is sold on to others for advertising.

Workplace performance can be a leading indicator of customer satisfaction

Retailers also need to increasingly see staff as key assets: keeping vital talent such as in-house designers and a motivated sales force with comprehensive product knowledge can make a major difference in a highly competitive marketplace.

Staff engagement is a highly intangible driver, but companies that get it right can see higher productivity, lower staff turnover and absenteeism, better innovation as well as lower injury rates. Importantly, staff engagement can also link with customer satisfaction. Super Retail Group's achievement at Rebel Sport is a good example of that.

Investors who do their homework can identify trends at an early stage. Our analysis focused on e.g. staff engagement surveys, staff development programs, occupational health and safety (OH&S), union relationships, gender diversity, investments in customer service and independent customer satisfaction research. That analysis led to a number of interesting insights.

Compared to other sectors, relatively few retailers disclose OH&S performance. This could indicate something about management: either they don't believe it is an important issue, or performance is poor or there is a lack of systems to capture OH&S performance.

While the retail industry might not intuitively spring to mind as a high-impact industry in terms of OH&S, it should be noted that the injury incidence rate remains high when compared to many other sectors and injury risk is high in distribution and warehouses.

Interestingly, among those that do publish OH&S stats, a high number of companies' lost time injury frequency rates (which in themselves are not the most ideal way to describe a company's OH&S performance) are worse than the industry average. Only one listed retailer had significantly better performance than the industry average. In many cases, OH&S performance has been poorly captured in the past and in some cases, the existing systems are inadequate for proper capture of safety performance. Surprisingly, one of the listed retailers had one of the highest lost time injury frequency rates among any listed company in the ASX100.

Most retailers disclose gender balances across the organisation. While most companies' customer-facing staff is fairly well matched against the gender of the customers, a number of cases were identified where there is a major imbalance between women as a percentage of the workforce versus management and the board. This can be a

leading indicator of staff turnover, engagement and productivity.

Leaders on diversity have diversity plans, including objectives and credible strategies to meet these. They also do gender pay gap analyses and act on these. However, for many companies this is not the case.

The retail sector is not highly unionised compared to many other sectors. However, retailers might be affected by industrial action in the transport sector. Unions have accused retailers of having business models that undermine road safety.

High insider ownership explains some of the structural corporate governance issues

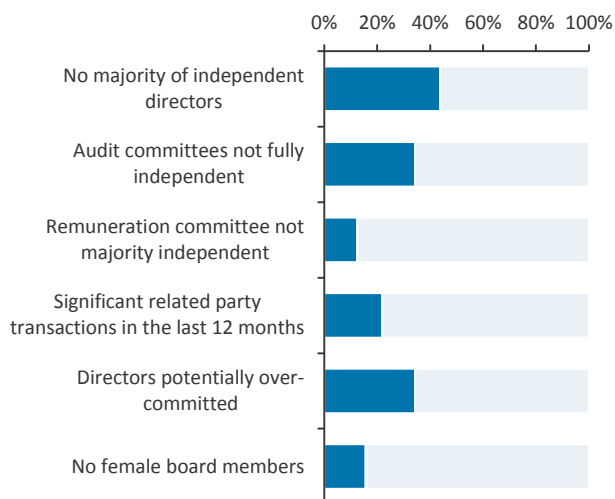
Of the 32 companies covered in our recent ESG review of the retail sector, 14 - in other words almost half - of the companies did not have a board with a majority of independent directors.

In addition, in 11 cases the audit committee was not fully independent and in four cases the majority of the remuneration committee consisted of non-independent directors.

These statistics should be seen in light of the high director and executive shareholding in the sector – a number of the companies have majority or near majority shareholders. Nevertheless, the poor board structures represent a risk to minority shareholders.

The analysis also highlighted a number of other risk flags for investors. For instance, in seven cases, material related party transactions were identified; many of the independent directors appear over-committed externally including directorships in three or more other listed companies and in some cases there appears to be a lack of financial and auditing skills among the members of the audit committees.

Listed retailers with ...



Source: AMP Capital as at October 2013.

The analysis also identified a number of remuneration structures where the long-term incentive is not linked to relative total shareholder return with risks of creating conflicting interests for management and shareholders. Other common concerns include cases of discretionary bonus systems, poor disclosure on incentive hurdles for short term incentives and significant cash pay increases despite poor share price performance.

Supply chain management, brand risk and operating risk and a proxy for managing complexity

Companies with smart and efficient supply chains can cut lead times, reduce inventory risks and generate cost benefits, which is important in an industry subject to increased competition and fast-changing fashion trends.

Direct sourcing from low-cost countries in Asia can offer cost benefits, but the cost benefits can be elusive and, as we highlighted in 'How sustainable are Australian retailers' sourcing strategies' in 2012, sourcing from countries like Bangladesh with major human rights issues, can have a poor financial risk / reward ratio. AMP Capital has actively engaged with companies on supply chain management, particularly in regards to risks in Bangladesh since 2011.

The way a company deals with its supply chain can be a good proxy for management quality and an indication of how well it manages complexity. Potential cost savings related to the move from manufacturing in China to Bangladesh need to be balanced against additional risks in terms of brand damage, longer lead times, product quality issues and more. Further, a minimum wage that does not cover basic costs of living will not be sustainable.



Photo from a factory in China from AMP Capital's supply chain field trip 2011.



Photo from a garment washing and dyeing facility in China from AMP Capital's supply chain field trip in 2012.

Since our field trips and research in 2011-2012, supply chain risk management has unfortunately become a very topical issue, particularly after the Rana Plaza building collapse in Bangladesh, which led to over 1,100 fatalities. Since then, many retailers have responded with increased focus on supply chain risk management, albeit often from a low base, and we are encouraged by these improvements, including signing up to the multi-stakeholder Accord on Fire and Building Safety in Bangladesh (Kmart, Target, Big W and Specialty Fashion Group).

However, most retailers' ethical sourcing frameworks remain based on local legal compliance only and, in some cases, we remain concerned about management's hands-off attitude to sweatshop risk, particularly given that the brand is a retailer's key asset. Currently, only one company (Pacific Brands Group) has signed the Ethical Trading Initiative (ETI), which, in our view, is one of the most robust ethical sourcing frameworks as it promotes a 'living wage', which is important from a sustainability perspective.

At least nine listed retailers in Australia and New Zealand have exposure to manufacturing in Bangladesh and a number of companies are also looking at Cambodia as a new alternative sourcing location. Cambodia has similar issues to Bangladesh, including poor factory standards and inadequate minimum wage.

The constant search for lower costs in the supply chain by certain companies may also impacted product quality. Our analysis of product recalls in recent years shows a distinct trend of increased product quality issues for these companies. While consumers might have low expectations on product quality in discount department stores, product recalls in certain categories, e.g. toys and appliances, can have some serious impact.

Conclusions

- > The retail industry is subject to more structural change than ever, but on the whole the Australian and New Zealand retail sector has been complacent and is now playing catch up in face of greater competition. While new initiatives on innovation on technology are no guarantees for success, lagging behind can become a recipe for failure.
- > There are fewer links between individual ESG factors and earnings and share prices in the retail industry compared to many other sectors. However, overall ESG performance can be used as a proxy for management quality.
- > ESG leaders in the retail sector are on the front foot of staff engagement and focus on creating retail 'careers' for their staff, which can result in increased staff engagement, higher productivity, lower absenteeism and better financial performance.
- > The factory accidents in Bangladesh have been a catalyst for greater focus on supply chain risk management. However, many retailers still have a hands-off attitude on supply chain risks and their ethical sourcing frameworks are focused on local legal compliance only.
- > The retail sector has a high proportion of insider ownership, but the poor board independence, the risk of value-destructive related party transactions and a number of issues with remuneration structures in the retail sector mean a risk for minority shareholders.
- > The sector is subject to significant changes, underpinned by technology change, changing consumer behaviour and more, which means retailers need to adapt and be innovative. Other emerging risks from an investor perspective include sourcing from Cambodia – a country with similar issues to Bangladesh – and legal and brand risks related to how retailers are capturing and capitalising on customer data.

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