Pay, pressures and priorities in the leisure industry

Janet Salmon, leisure industry management consultant

Employing more than a fifth of the UK workforce and with market capitalisation equalling close to 8 per cent of all FTSE 500 listed companies, leisure firms are vital to our economic prosperity. But the industry is rapidly changing and the market is becoming highly competitive. In the light of these developments, Janet Salmon, a consultant specialising in the leisure sector, asks how the industry's executives should be rewarded in the face of these challenges.

Smoking bans, longer opening hours and environmental issues make these testing times for leisure companies and to ensure they maintain a competitive advantage they will need appropriate reward policies for their top executives. Leisure companies are recognising that such pressures will inevitably have an affect on their business strategies and influence their remuneration approaches. In this rapidly changing business environment companies thinking about their executive rewards will need to consider a number of questions. These include:

- what specific remuneration strategies can they develop to support their business priorities and minimize risk?
- are executives' rewards aligned to the company's strategic targets?
- how can the board ensure shareholder support for the company's priorities and reward strategy?
- how to ensure financial rewards reflect excellent performance at all levels?
- would a fairer distribution of reward increase company success?

Changing business climate

Before going on to address these questions in more detail, I think it is worth looking in more depth at the challenges facing leisure firms. One is the consolidation of leading companies and brands into larger groups, which poses the challenge of whether they can actually offer better products or service to the consumer. At the same time, individual hotels and small, distinctive groups are competing with the larger brands, while niche hotels aim to offer a personal service, competing on the reputation of their brand and price. Further, running successful franchises is always difficult whilst maintaining quality and company culture and, at the moment, it seems Caffé Nero is more successful in its approach than Coffee Republic.

Additionally, Government restrictions on smoking, along with its desire to put more responsibility on the industry for customer drinking and behaviour will change the environment for pubs and clubs. As a consequence, in the future, general managers and staff are going to need maturity and excellent people management skills. There are also external environmental issues facing the industry, such as tax increases on flights and larger cars which will affect distant, isolated venues. Hotels and leisure facilities will have to reduce their water usage and waste, cut energy bills and build sustainable venues.

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Other challenges include controlling costs and maximising the profitability at each site. The cost of high street leases has increased, for example, and this is forcing out the smaller players and increasing insolvencies. But landlords should recognise that customers find a high street more attractive if there is a

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mix of small and larger venues and not merely national brands which make all shopping areas identical. From the demand side of the equation, with unemployment rates going up, fear of unemployment dampens consumer spending, reducing leisure activity, club memberships and profits.

Impact on leisure company remuneration strategies

If they are to respond to these pressures and challenges, leisure companies should consider how they may need to adjust their senior remuneration strategies. Many companies, for instance, recognise that business targets affect their remuneration approach and if they plan to expand the number of franchises, hotels or health clubs this will need to be built into their bonus schemes. These reward schemes may also have to emphasise qualitative criteria such as guest satisfaction and retention of membership. The main issue, however, is whether executive rewards are aligned to the company's strategic targets and whether they encourage executive actions to deliver company growth and shareholder return.

Although some 72 per cent of incentive schemes in the FTSE 350 choose earnings per share (EPS) as their main performance criteria, this may not be the most suitable measure to reflect the performance of individual directors or the company. Most leisure companies either compare the growth of their EPS relative to the Retail Prices Index or a comparator group or the FTSE Leisure Index, but rewards at the median may not be challenging and some targets seem to trigger automatically. Shareholders may then feel these incentives are used to retain executives rather than reward exceptional performance. What is important is that financial incentives should be tailored to the key employees' responsibilities.

This alternative approach is illustrated by Diageo which links its incentives to return on capital employed (ROCE). The advantage of ROCE is that it gives an indication of the financial health of a company and can be used in conjunction with other financial indicators that fit the business strategy. Using this measure Diageo achieved an average of 14.6 per cent on its ROCE between 2002 and 2005. But even this measure is not without its concerns, as Hilton's record illustrates. Hilton achieved a 23.6 per cent ROCE in 2005 as against 7.3 per cent and 5.1 per cent during the previous two years, which seems good at first glance. But this was done by disposing of £3.6 billion in assets and whether this reflects a good financial strategy in the long-term remains to be seen.

Boards need shareholder support for reward strategies

To maintain their reward strategies and priorities when facing up to the new market challenges leisure companies will need to ensure that they gain shareholder support. Shareholders who have seen the return on their investments fall are inevitably going to question why the cost of boards continually rises due to generous executive bonuses, long-term incentive schemes and share options. When companies split up or have management buyouts, as is happening at the moment, then it is crucial that directors don't make greater financial gains than the shareholders. Additionally, companies that merge or separate need to establish a new remuneration strategy. One such company, Ladbrokes, will complete a full review of its reward strategy in 2007 and shareholders will find out whether their board costs will increase. If executive remuneration goes up sharply, Ladbrokes' shareholders should ask

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whether the company is more complex and difficult to run than when it was part of a bigger group.

All this raises the issue of how companies can ensure that financial rewards reflect excellent performance at all levels. A good example of this is The John Lewis Partnership which performs consistently well and its success is driven by the fact that it is a partnership. All employees receive the same percentage of their salary as a bonus depending on the achievement of its targets. They also recruit high-quality, motivated staff – and it shows. On the other hand, some leisure companies seem to take the opposite approach with generous rewards given to directors while employees receive just above the minimum wage and tips. Poor pay produces low motivation and high staff turnover, affecting training, customer-care and succession planning.

When chief executives receive bonuses of £500,000 or £1.3 million, while the average salary of their employees is equal to just 2.2 per cent or 4.2 per cent of the chief executive's, then the balance of risk to reward seems to have swung too far. Reward and recognition, spreading down through the organisation is important.

Fairer distribution of success

The existence of such disparities leads me on to another question that I think leisure companies need to address – would a fairer distribution of reward increase company success? Are executive rewards seen as fair and do they motivate people? All the evidence suggests that the key to excellent performance in the long run is a challenging, supportive and open working environment. Fair rewards would certainly improve the industry's image, attract better-qualified staff and reduce staff turnover. Relying on overseas staff is not a long-term solution and we need to train and develop young people who will have a long-term career in the industry.

Another area where current reward strategies may need to be looked at is retaining key employees in the light of a high turnover of staff. In these circumstances employers often simply increase salaries, but this is not the solution. Employees at all levels move if they feel frustrated or do not agree with the company's priorities or overall strategy. As well as looking at salaries, therefore, directors will have to communicate with their employees and make them feel involved in the overall company strategy. Moreover, managers who reduce staff turnover give their companies the chance to develop employee skills and promote internally, while respected senior management who were promoted from the shop floor can often work effectively with their team to generate profits. But while higher pay is not always the solution, remuneration committees need to recognise that they will probably have to pay more to recruit new directors so regular benchmarking reduces that risk.

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Finally, in many leisure companies executives are still in final salary pension schemes, while their employees are in less generous defined contribution plans. For the sake of equity chief executives should be in the same scheme as their staff. Companies used their pension surpluses in the 1990s, but their employees are the ones affected. This won't build successful, motivated companies.

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