

Living Wage: a UK perspective

Elly Irving, ESG Analyst, Schroders

The living wage is gaining momentum in the UK. The number of companies committed to paying their workers the living wage has doubled during 2014 and now numbers 400. The living wage topic has relevance across the globe; however, in this note we focus on the UK. We assess the associated costs and benefits of paying a living wage, which sectors have the most exposure to this issue and the impact it has on margins.

Political pressure puts the UK living wage on the agenda

There are several reasons why the living wage debate is gaining momentum in the UK, and political pressure is one of them. London's mayor, Boris Johnson, has stated that he wants the living wage to become the norm across the city.

In addition, there has been a greater focus on income inequality in the media. Shareholders are increasingly using voting rights to highlight employee-related issues such as workforce diversity, and the living wage could be the next area matter to grab engaged shareholders' attention.

Finally, in a global context there is rising awareness of living wages. In the US, several major retailers including Wal-Mart and T.J. Maxx have committed to increasing wages ahead of potential legislation that would take the federal minimum wage from \$7.25 to \$10.10 an hour. In emerging markets, there has been a significant increase in the minimum wage in both Bangladesh and Cambodia in response to large scale employee strikes. It should be noted that many UK companies sourcing from emerging markets have a commitment to paying a living wage along their supply chain, however, very few companies are able to demonstrate that this has been achieved.

The current living wage in the UK

Globally, there are many different definitions for a living wage; in general it should enable the earner to afford shelter, food, clothing, transport, healthcare and basic necessities.

In the UK there are two official living wage levels, which are re-calculated annually and take into account issues such as housing costs, council tax and a regular shopping basket. As at November 2014 these were set at:

UK living wage¹: £7.85 an hour London living wage²: £9.15 an hour
UK national minimum wage: £6.50 an hour

This is a relevant issue for UK companies as there are currently 5.24 million workers (21% of the UK workforce) that are paid a wage below the living wage. However, it is important to note that there is a significant difference between full-time and part-time workers. Within London, 87% of full-time workers earn a wage equal to or greater than the living wage, but this drops to only 51% of part-time workers.

Costs and benefits of the living wage

Why should UK-listed companies consider introducing a living wage? Below we summarise the costs and the benefits of this practice.

Costs

Cost per employee

UK-listed companies are facing increasing stakeholder pressure to pay a living wage. There are clear financial costs to implementing this practice. Some estimates suggest that moving from the national minimum wage to the UK living wage, including the increased pension, national insurance and tax contributions would cost £2,400 a year, per employee.

Impact on corporate earnings

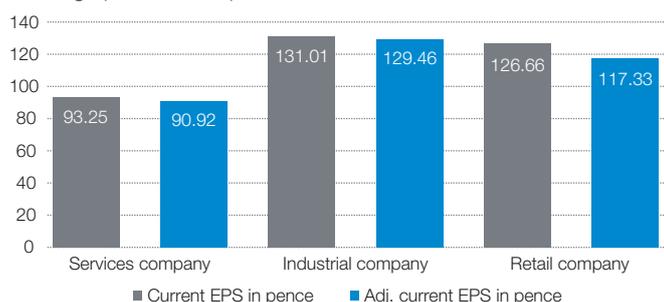
ShareAction³ has calculated the impact of introducing a living wage on a company's earnings per share (EPS). Their analysis shows that the greatest impact will be to the retail sector, where there is a larger number of sub-living wage earners.

The impact of the living wage on corporate earnings

Adjusted anonymised outputs	Services company	Industrial company	Retail company
Share Price	1202p	2055p	2256p
Current EPS	93.25p	131.01p	126.66p
Adjusted Current EPS	90.92p	129.46p	117.33p
EPS Difference	-2.5%	-1.2%	-7.4%
Current P/E ⁴	9.02x	10.98x	6.23x
Adjusted Current P/E	9.25x	11.11x	6.73x
Required P/E Expansion	2.6%	1.2%	7.9%

¹ The UK living wage is calculated by the Centre for Research in Social Policy at Loughborough University and is a weighted average of the wages required to cover basic living standards across nine different household categories. The increase is capped. ² The London Living wage is calculated by the Greater London Authority (GLA). ³ A group promoting responsible investment across the pensions industry. ⁴ The price to earnings ratio of each company. (Price to earnings ratio is the valuation ratio of a company's current share price compared to its per-share earnings.)

Earnings per share in pence



Source: ShareAction, The Case for the Living Wage, November 2014.

Maintaining wage differentials

Paying a living wage may also create an additional cost if a company wishes to maintain wage differentials across the whole workforce.

Benefits

Companies such as Barclays, SSE and Accenture, all of whom have committed to paying a UK living wage, have seen many benefits as a result. These include:

Lower employee turnover

Studies have shown that paying a living wage has increased employee motivation and loyalty, which is evident from lower turnover rates. While the financial value of these benefits is more difficult to quantify, some sector-leading companies are starting to capture this data. For example, SAP, the German software company, reports that for every 1% improvement in employee retention rates, operating profit improves by €60 million⁵. Meanwhile, Barclays state that its catering staff retention rate increased from 54% to 77% following the introduction of the living wage, and its retention rate for cleaning staff rose from 35% to 92%⁶.

Low staff turnover can have additional benefits such as:

- Lower recruitment costs
- Lower productivity loss
- Lower costs resulting from poor hiring decisions

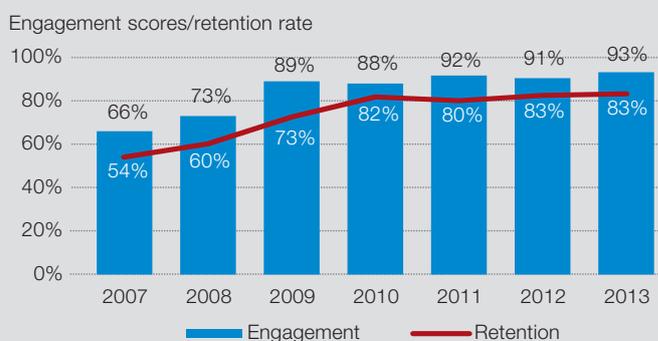
Lower absenteeism

A recent study by PWC (a professional services firm)⁷ states that employee absenteeism in the UK is higher than rates in both Europe and the US, with UK employees taking an average of 9.1 days off per year. The total absence cost to UK businesses is now at £29 billion a year. The highest rates of absence are in the retail and leisure sectors, which correlates with the highest proportion of sub-living wage workers.

Case study: Halfords and Pets at Home

For specialty retailers, such as Halfords and Pets at Home, the level of employee product knowledge directly correlates with sales, so there is a clear business case for linking pay increases with up-skilling. However, the business case may be weaker for general retailers. Both of the above companies saw an increase in employee productivity and better customer service after implementing an up-skilling programme, which have fed through to significant increases in like-for-like sales growth. The graph below demonstrates the employee retention and customer engagement improvements at Pets at Home resulting from the up-skilling programme, and the growth in sales over the same period.

Improvements in customer engagement scores and employee retention



Source: Pets at Home IPO Prospectus, 2014.

A similar up-skilling programme was introduced at Halfords in June 2013 which awarded a living wage for the highest level of training achieved. As a result, the company has already witnessed a significant fall in employee turnover. While a number of other initiatives have been launched under the new management, the employee trends have contributed to the material improvement in like-for-like sales growth, reflected in the share price as shown below:

Halfords share price



Source: Bloomberg, 25 February 2015.

⁵ SAP Annual Report 2013. ⁶ The Case for the Living Wage, ShareAction, 2014.

⁷ PWC Blog <http://pwc.blogs.com/northern-ireland/2013/07/sickness-costs-uk-business-29bn-a-year-and-growing-pwc.html>, 2013.

Increased productivity

Some of the most successful examples of introducing a living wage have been where it has been implemented alongside an up-skilling programme (which can help to increased productivity) and the introduction of skills-based pay. Skills-based pay is a reward structure that aligns higher levels of pay with additional skills, knowledge and competencies. A study looking at the business case for the implementation of the living wage⁸ found 61% of respondents now 'do a broader range of tasks' after introducing skills-based pay.

Furthermore, the Living Wage Commission suggests that paying a living wage could close the gap in productivity levels in the UK compared to other G7 countries. Professional services company KPMG reports that the UK's output per hour is 21% lower than the average for the USA, Germany, France, Italy, Japan and Canada⁹. Another study showed that worker productivity is higher when staff were viewed as an asset by retailers, rather than an area for cost cutting.

Better customer service

UK employers who introduced a living wage also witnessed an improvement in customer satisfaction and lower complaints. This is especially true of the more specialist retail and leisure sectors where there is potential for significant motivational and productivity gains amongst the workforce. Companies such as Halfords, have seen a significant improvement in customer service since implementing an up-skilling programme that links the living wage with the level of training achieved¹⁰.

Attracting and retaining talent

In increasingly competitive markets, employers are in a race for talent. In Wal-Mart's recent announcement to raise pay for 40% of its US workforce, its chief executive officer (CEO) attributed the decision to attracting and retaining talent, saying that "today's cashiers will be tomorrow's store or club managers. Today's managers are tomorrow's vice presidents. Tomorrow's CEO will almost definitely come from inside our company"¹¹.

Multiplier effect

Given that means-tested benefits, including council tax benefits and working tax credits are already incorporated into the living wage calculations, living wage earners will see an increase in disposable income. Studies have shown that when lower income workers receive higher pay, they are more likely to spend it rather than put it into savings. For example, research by the Bank of England showed that for every pound lost in income for lower income households, spending is reduced by 78p. For higher income households, the reduction is just 45p¹². The businesses that introduce a living

wage are best placed to benefit from this increased spending power, notably the retailers, restaurants and bars.

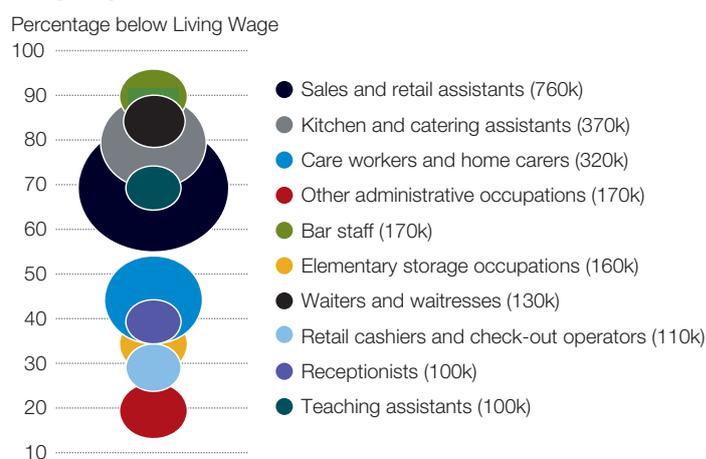
While there is strong evidence of the benefits from paying a living wage, the time horizon for these benefits is unclear. If the living wage becomes standard practice, then benefits such as attracting talent and lower turnover may decrease over time. However, introducing up-skilling along with a living wage may be one way for employers to differentiate themselves from their peers and ensure that the benefits continue. Considering time horizons also highlights the potential benefits of a first mover advantage. The companies who introduce a living wage ahead of sector peers are more likely to see greater benefits over the short term.

Retail sector most exposed in the UK

So far, the majority of companies that have signed up to the UK living wage are in the financial services, insurance and banking sectors. These sectors tend to have a lower proportion of sub-living wage workers, and subsequently the cost of increasing salaries represents a much smaller proportion of total employee-related costs. Beyond the financial sectors, there have been a number of companies listed overseas with UK operations that have signed up to the living wage, including Nestle and Google.

Research from KPMG suggests that the hotel, restaurants and leisure sub-sector employs the largest proportion of sub-living wage workers. For example, the graph below highlights that 90% of bar staff earn less than the living wage, but the retail sector employs the largest absolute number of sub-living wage workers with 760,000 UK-based workers. So for investors, this may mean a higher level of employee turnover and lower productivity per employee than other sectors.

Occupations with greatest number of people below living wage: all UK



Source: Living wage research for KPMG, Markit, 2014.

⁸ The Business Case for the Living Wage, Jane Wills with Nathalie Kakpo and Rahima Begum Queen Mary, University of London, January 2009. ⁹ Living wage research for KPMG, Markit, 2014. ¹⁰ <http://halfords.annualreport2014.com/strategic-report/strategy/milestones>. ¹¹ Wal-Mart announcement on 19th February 2015 <http://blog.walmart.com>. ¹² Working for Poverty report, Living Wage Commission, 2014.

Savings partially offset the costs in UK retail sector

We conducted some analysis on the potential costs and benefits of introducing a living wage in the UK. Our proprietary research highlights a material cost in reaching living wage, ranging between 1 – 2% of UK revenues. However, the potential savings achieved through lower absenteeism and lower turnover offsets between 16% to 36% of these additional costs.

While the range of potential benefits is broad, we note that speciality retailers are best placed to benefit from introducing the living wage. With higher margins, it is more feasible to invest in staff, and the resulting improvement in customer service is likely to have a greater impact on sales, as demonstrated by the Halfords and Pets At Home case study.

An important part of our engagement strategy

As part of our engagement strategy, we have spoken to a number of different companies across the consumer sector on the topic of living wage. While very few consumer companies have become accredited living wage employers, there is some evidence of pay increases and up-skilling programmes. Some employers monitor the proportion of the workforce that is paid a living wage, but they don't disclose it publicly. Others are struggling with the definition of the living wage, and while in the UK there is a clear sterling number attributed to both the London and UK living wage, this is not the case in all countries.

Another trend identified in the consumer sector is the use of zero hour contracts. While this approach has been the centre of much debate, companies note that this flexible working solution can suit certain segments of the workforce, such as students and semi-retired workers. We will continue to engage with companies to better understand the costs and potential benefits that can be gained from introducing a living wage on a case by case basis.

This document is issued by Cazenove Capital Management which is a trading name of Schroder & Co. Limited, 12 Moorgate, London, EC2R 6DA. Authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority. Issued in the Channel Islands by Cazenove Capital Management which is a trading name of Schrodgers (C.I.) Limited, licensed and regulated by the Guernsey Financial Services Commission for banking and investment business; and regulated by the Jersey Financial Services Commission.

Nothing in this document should be deemed to constitute the provision of financial, investment or other professional advice in any way. Past performance is not a guide to future performance. The value of an investment and the income from it may go down as well as up and investors may not get back the amount originally invested.

This document may include forward-looking statements that are based upon our current opinions, expectations and projections. We undertake no obligation to update or revise any forward-looking statements. Actual results could differ materially from those anticipated in the forward-looking statements.

All data contained within this document is sourced from Cazenove Capital Management unless otherwise stated. For your security communications may be taped or monitored. D15041.

Investment conclusions

There is increasing pressure from a broad range of stakeholders on companies to pay a living wage. While there are clear direct costs, it is estimated that these will impact EPS by between 1 – 7%¹³ depending on both the sector and individual company. However, while difficult to quantify, and the underlying assumptions may vary, it appears that the benefits are significant. Both the costs and benefits are greater for the retail and leisure sectors. Potential benefits include increased employee productivity, higher retention rates, lower employee turnover, the ability to attract higher quality candidates and improved customer service.

All of these factors could have a positive impact on sales and reduce costs in the long run with lower training, recruitment and employee absence costs. However, the cost and benefits differ not only between sectors, but also within sectors. Within the retail sector, for example, it may be more feasible to pay a higher wage amongst speciality retailers where margins are larger and the potential benefits are greater. Improvements in customer service are likely to be more material when selling a speciality, one-off good, rather than everyday items. While there are clear benefits of introducing a living wage, this issue should be considered on a case by case basis.

¹³ The Case for Living Wage, ShareAction, November 2014.