



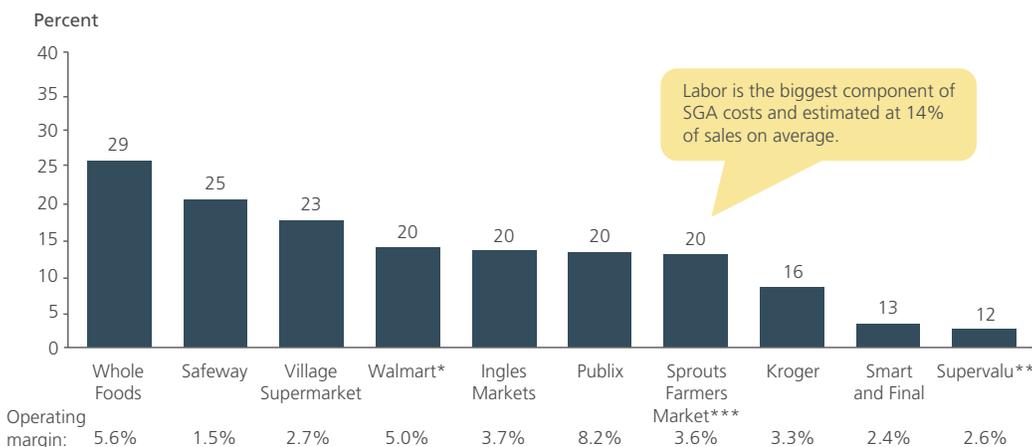
Rising Labor Costs — and What Retailers Can Do About Them

The grocery and broader retail industry is at a turning point. In recent years, retailers and grocers have seen rapid evolution, thanks to trends such as consolidation, changing customer preferences and competition from disruptive innovators, chief among them Amazon. Meanwhile, margins — always notoriously thin — have come under stress from rising labor costs.

The hourly wage landscape

How much stress? Take a look at the selling, general and administrative (SGA) costs for 10 of the largest U.S. grocers. Note that labor is the biggest component of total SGA costs and estimated at [14% of sales](#) on average (see Figure 1). And labor's share is growing. The retail industry has many hourly workers — roughly 11 million in 2015, according to the U.S. Bureau of Labor Statistics (BLS). Hourly earnings for nonsupervisory food and beverage store employees have gone up about 1% every year since 2010, with much of that growth coming from the 322,000 workers who earn minimum wage or less.

Figure 1
Selling, general and administrative expenses as a % of net sales (2015)



Operating margin: 5.6% 1.5% 2.7% 5.0% 3.7% 8.2% 3.6% 3.3% 2.4% 2.6%
 Note: *Fiscal year Jan. 31, 2015-2016; **Fiscal year Feb. 27, 2015-2016; ***Direct store expenses (all others are OG&A or SG&A)
 Source: Company 10-Ks

Wage growth hasn't come from the federal level.

Starting in 2005, the federal minimum wage rose 41% until it reached \$7.25 an hour in 2009. But there it has stayed, as if frozen in time. Despite calls from the Democratic Party to raise it to \$15, nothing is likely to happen with the federal minimum wage under the current administration. Republicans in Congress have tended to [oppose](#) a hike, saying it would [harm small businesses and eliminate jobs](#). Meanwhile,

Rising Labor Costs — and What Retailers Can Do About Them was written by **Chris Randall** and **Rob Wilson**, Managing Directors in L.E.K. Consulting's Consumer Products and Retail practice.

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President Trump has said that while he'd like to see an increase, he'd prefer to [leave it to the states](#).

States and localities have forged ahead on their own. More than half of the states have raised the minimum wage since January 2014. Today, the minimum wage sits above the national level in 29 states plus the District of Columbia (see Figure 2). And this trend shows few signs of abating. At the beginning of 2017, minimum-wage workers [received a raise](#) in 19 states. What's more, 18 states and the District of Columbia have indexed their minimum wage for inflation, meaning it automatically adjusts each year for price increases. A dozen states, covering roughly 30% of the U.S. population, have announced particularly aggressive plans to grow their minimum wage over the next few years — from 5% in Vermont to 12% in Maine (see Figure 3).

Overtime pay is also in play. Another wage increase — to the tune of roughly \$1.2 billion a year — could come via federal regulation, although the outcome is uncertain. In May 2016, the U.S. Labor Department issued the Final Rule of the Fair Labor and Standards Act, extending overtime protections to more than four million full-time workers.

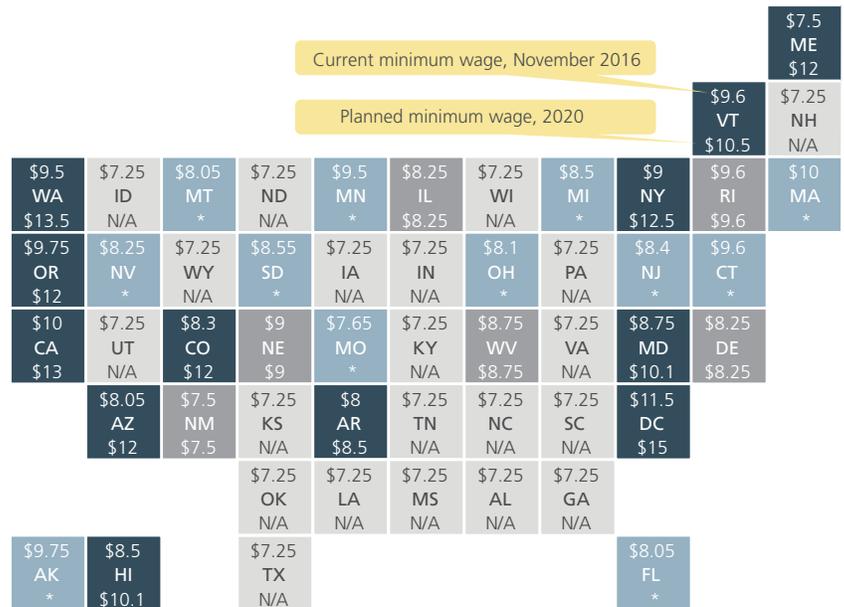
Under the rule, overtime pay would become available to employees earning up to \$47,476 a year. The current threshold is \$23,660 a year. The rule was scheduled to go into effect last December, but shortly beforehand, a Texas federal judge [halted](#) it with an emergency injunction. Although the Department of Labor [filed a motion](#) to expedite the briefing on a recent appeal, implementation for now is delayed.

Should the law move forward, retailers will be forced to adapt current work schedules or invest in technology to reduce the number of total labor hours and avoid higher labor costs. According to the National Grocers Association, this could have "[dramatic consequences for independent grocers](#)" facing significant competition. The Food Marketing Institute weighed in with concerns over the "[scheduling and financial impact](#)" of changes in the final rule.

Major retailers aren't waiting for regulators

In February 2016, Walmart and its subsidiary Sam's Club raised wages to \$10 an hour. Target soon did the same, while Costco boosted its minimum wage to \$13. Regionally, wages rose due

Figure 2
State-level minimum wage (2016, 2020)



- Currently above minimum wage, significant growth planned
- Currently above minimum wage, indexed future growth
- Currently above minimum wage, no increase planned
- Currently at minimum wage, no increase planned

Note: *Indexed with inflation
Source: Economic Policy Institute

to union negotiations at a number of other grocers, including Safeway, Ralphs, Kroger, Giant, Stop & Shop, Schnucks and Albertsons (see Figure 3 on page 3).

When Walmart announced its wage increase in late 2015, observers predicted that competitors of the nation's No. 1 retailer would have to follow suit or face problems holding on to their best employees. At the same time, the wage hike could [add another \\$4 billion](#) to large retailers' labor costs. This profits-versus-talent dilemma seemed to play out in Walmart's January 2017 [elimination](#) of nearly 1,000 corporate jobs.

How grocers and retailers can respond

In light of these trends, what can retailers do to address rising labor costs? The simplest solution is to wait and see, and then try to pass on price increases to the consumer. However, we believe industry turning points like this one present a unique opportunity to create new competitive advantages. To do this, we recommend that grocer and retailer executives explore opportunities along five dimensions:

Figure 3
Retailers' minimum-wage increases



Note: *Based on 2015 revenue, Walmart owns Sam's Club and extended pay raises across businesses.

Sources: Business Insider, Reuters, Huffington Post, Boston Globe, Cincinnati Business Courier, St. Louis Business Journal, Supermarket News, The Baltimore Sun, USA Today

1. Optimize customer-facing labor while maintaining service
2. Drive efficiency in non-customer-facing activities
3. Find opportunities to outsource labor-intensive activities
4. Drive higher margin sales through assortment/merchandising
5. Use cutting-edge pricing and promotion techniques

To understand where the opportunities could be, let's take a closer look at each potential strategy.

Optimize customer-facing labor while maintaining service

To pull off this strategy, grocers must decide where they can reduce (or otherwise optimize) customer-facing labor without unduly affecting the customer experience. In many cases, technology can be the solution, especially when considering ROI against higher labor costs. However, opportunities also exist to rethink standard practices and eliminate offerings that consumers don't especially value.

- **Reduced hours, more customer self-service.** Aldi [minimizes labor costs](#) by limiting store hours to normal business hours, eliminating traditional service counters (such as butchers) and requiring customers to bag their own groceries. The Germany-based grocer also requires a 25-cent shopping cart deposit, which reduces the need for employees to chase after and return carts.
- **In-store customer tracking.** In 2016, Kroger installed a customer-tracking system that tells managers how many customers are in the store and how many checkout lanes to open. With this move, the supermarket chain expects to save \$250 million in annual labor costs via lighter staffing and more

efficient scheduling. The new system is also expected to slash average customer wait times from four minutes to 30 seconds.

- **Combined service counters.** Whole Foods [consolidated](#) the meat and seafood sections in some of its stores to eliminate extra staff and reduce overall hours.
- **Self-checkout via mobile app.** Walmart is testing a new version of its "Scan and Go" app, which lets customers skip the checkout line. Instead, customers scan their grocery items as they shop, complete their purchases online and simply show their receipts on the way out.

Drive efficiency in non-customer-facing activities

- Here, the key question is which non-customer-facing activities can be streamlined to help offset rising in-store labor costs. As it turns out, grocers are finding opportunities in two business areas: technology and sourcing.
- **Temperature monitoring systems.** Kroger recently invested in a system that regulates and reports all refrigerator temperatures within a store. The system cost \$50 million but is expected to [save \\$250 million a year](#) in labor because people will no longer have to manually track temperatures.
- **Electronic labeling systems.** E.Leclerc is a grocery store in France, where labor costs are already much higher than in the U.S. The chain uses electronic labeling systems that can change prices across stores all at once. This eliminates not only the cost of labor to hand-change paper labels, but also the cost of mislabeling items.
- **Advanced scheduling applications.** United Supermarkets' phone applications let employees change their schedules remotely, arrange last-minute shift changes and clock in as they enter the store. All of this reduces managerial workload and raises overall productivity.

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Find opportunities to outsource labor-intensive activities

Grocery and other retailers have a broad selection of service providers that can take on labor-intensive store functions for them. So for this strategy, the key question is which activities make the most sense to outsource. Certain ones offer particular benefits from a cost and efficiency perspective.

- **Resets.** Some outsourcers can tackle full-store rearrangement, typically overnight or during a store closure.
- **On-site marketing.** There are vendors that provide in-store sampling and experiential marketing to drive sales.
- **Product management.** Retail consultants can help grocers optimize shelf conditions and ensure high-volume products are stocked and visible.
- **Data collection and reporting.** Business intelligence specialists offer daily reporting and analysis of big data to support fact-based decision-making.
- **Value-added foods.** More retailers are turning to commercial kitchens for value-added options such as freshly prepared foods, bakery goods, deli items and fresh-cut produce.

Drive higher margin sales through assortment/merchandising

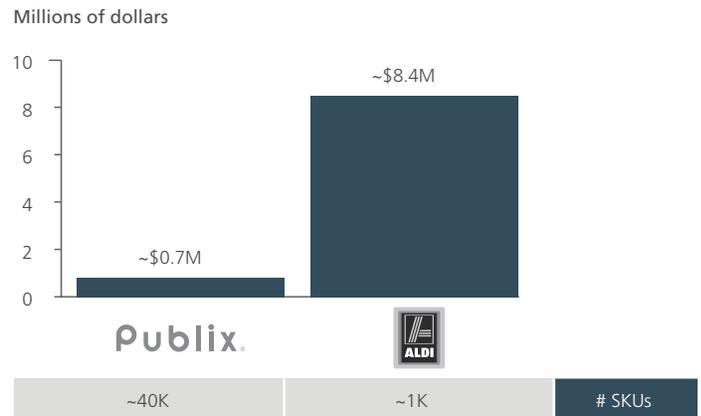
To boost profits, some grocery stores turn to private-label brands or other high-margin products. The key question is how to optimize the product assortment and store merchandising so that they encourage sales of those more profitable products. Large retailers have their own spin on this issue.

- **Strategic sourcing.** Unlike most grocers, Aldi carries [just one private-label SKU](#) for many of its products. This pared-down approach saves store and warehouse space, minimizes shipping costs, takes less work to stock products, and concentrates Aldi's buying power. The smaller range of SKUs also translates into [lower prices and nimbler responses](#) to business conditions (see Figure 4).

Other grocers are pursuing more robust private-label strategies. These include multitiered branding as well as broader category participation to ensure they capture attractive margins throughout the shopping basket.

- **Kroger.** At Kroger, private-label comprised [26% of sales](#) in 2015. Kroger's private-label products come in four tiers: best, natural and organic, better, and good. The company says it manufactures 40% of its corporate brand products, adding further heft to its margins.

Figure 4
Grocery retailer sales per SKU (2013)



Sources: Aldi, Fortune, Retailing Today, Supermarket News, What's In Store by IDDBA

- **Costco.** [One-quarter of Costco's 2014 sales](#) came from private-label products. The warehouse operator's Kirkland Signature label is positioned as a premium brand that members can buy for considerably less than national-brand equivalents. At 18%, Costco's private label claims a bigger share of sales than other club stores on average.
- **Whole Foods.** As of 2015, prepared foods accounted for 20% of Whole Foods' revenues. The supermarket is capitalizing on growing demand for portable and prepared meals and fresh produce. These act as premium products and return higher profit margins. (It's worth noting that Whole Foods has outsourced its food-prep operations in pursuit of greater efficiency, more flexibility and higher return on capital.)

Use cutting-edge pricing and promotion techniques

Grocery stores can increase their margins by improving the way they analyze, set and deliver prices to the marketplace. But for this strategy to work, grocers must answer two key questions. First, how will they adjust pricing for higher labor expense? Second, is there room to revamp the promotional strategy for greater revenue?

- **Electronic pricing solutions.** Grocery supplier Associated Food Stores creates dynamic and competitive pricing with the help of price optimization software. The software lets users apply historical information (prices, sales performance, time of day, etc.) and competitive benchmarking to calculate a price that maximizes profit. Similar solutions exist to measure promotional effectiveness and sales cannibalization across different grocery items.

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- **Customer loyalty programs.** After experimenting in several test markets, Whole Foods is [getting ready to offer](#) a national membership discount program. The supermarket chain discovered that a simple loyalty program with coupon integration was more effective than a game-like point system that offered rewards to frequent shoppers.
- **Digital coupons.** Wegmans distributes targeted coupons via email and its mobile app. Users can automatically redeem these offers at the point of sale, enhancing marketing efforts and transforming the grocery shopping experience. For store owners, digital coupons produce customers who make 23% more trips to the store and spend 50% more per year than the average shopper.

Conclusion

Several factors are coming together to drive up labor expense. One is government intervention, which today is taking place mainly at the state and local levels. Another driver is competition from national retailers. Finally, unions are once again asserting themselves in the compensation discussion.

In response, leading grocers and retailers are strategically shifting the status quo. They're taming labor costs through optimization of customer-facing activity and by selective outsourcing of labor-intensive processes. They're taking labor out of the back office via technology and strategic sourcing. And they're reducing labor's effect on margins with innovative approaches to product assortment, store merchandising, pricing and promotion.

Turning points are disruptive by definition. But they're also catalysts for breakthroughs. Retailers can create meaningful competitive advantage as long as they're proactive, maintain executive focus and systematically identify the right solutions for each retail business. For those who don't want to risk being on the wrong side of this turning point, it's smart to put labor cost planning and margin management on the strategic agenda.

Editor's Note: This *Executive Insights* includes hyperlinks to a number of sources for readers seeking access to supporting articles.

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