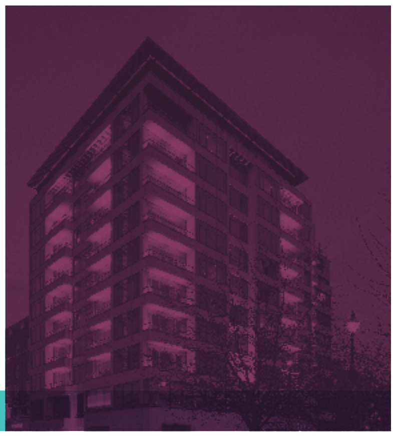
Is the National Living Wage creating National Living Rage?

The Perspective from UK Businesses

Christie + Co gauges the market's initial reactions to the National Living Wage's shockwave, giving its expert opinion on the questions, opportunities and challenges triggered by the proposed changes in legislation.

Christie + Co
BUSINESS INTELLIGENCE



Introduction

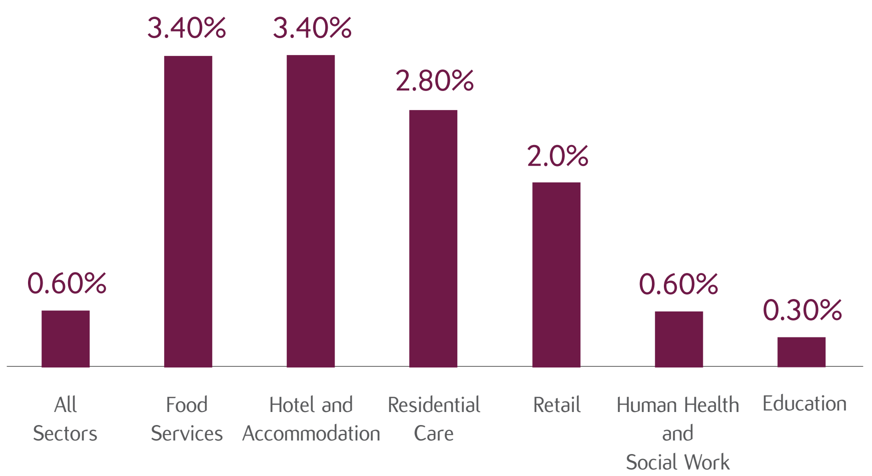
First introduced in the UK in 1999, the National Minimum Wage (the NMW), and its potential impact on UK businesses prompted debate and divided opinions at the time. A decade and a half later, the debate has been reignited with the revelation of the National Living Wage (the NLW) announced to replace the NMW for workers aged 25 and over. The NLW will be initially set at £7.20 per hour in April 2016, with the government planning on ambitious wage growth to over £9.00 by 2020. These rates are not arbitrary, corresponding to 55% and 60% of the median salary for workers above 25 in the UK, in 2016 and 2020 respectively, according to the recent publication from the Resolution Foundation think tank “Taking up the floor, exploring the impact of the National Living Wage on employers” September 2015.

Despite the obvious benefits for employees, the UK labour market is bound to experience significant changes and employers are preparing for major challenges. According to the Office for Budget Responsibility, primary analysis estimates that 23% of the total UK workforce (c. 6m employees) will benefit from the NLW increase by 2020, leading to a £4.5bn total wage increase across the country. These numbers also reflect the additional cost of wage compression to maintain salary differentials and pay equity, as a large share of employees are currently paid just above the future NLW.

Undoubtedly, the extent of the impact will be very uneven across sectors, as workforce characteristics and remuneration levels differ widely across industries. The vast majority of sectors covered by Christie + Co are not only labour intensive, but also highly dependent on low-paid labour. In their September 2015 publication, the Resolution Foundation commented that hospitality and social care are sectors where the impact is expected to be the highest, with total wages expected to increase by c. 2.5% on average. This analysis also shows that this measure will benefit one out of two employees in the hospitality sector (Restaurants, Hotels, Events Management, Catering, Pubs and Bars), despite a large proportion of this industry’s workforce being under 25.

In the context of various debates taking place around the introduction of the NLW, we give our experts’ opinion on this key issue and share initial reactions from our business partners and key industry players. Our sector heads identify specific challenges and opportunities in their respective sectors: Hotels, Pubs, Restaurants, Care, Childcare, Convenience Retail and Medical; as well as potential mitigating solutions. Our care sector head, Richard Lunn, also comments on whether the announcements of the joint 2015 Spending Review and Autumn Statement can compensate the care sector for the National Living Wage costs.

Estimated wage increase by sector by 2020

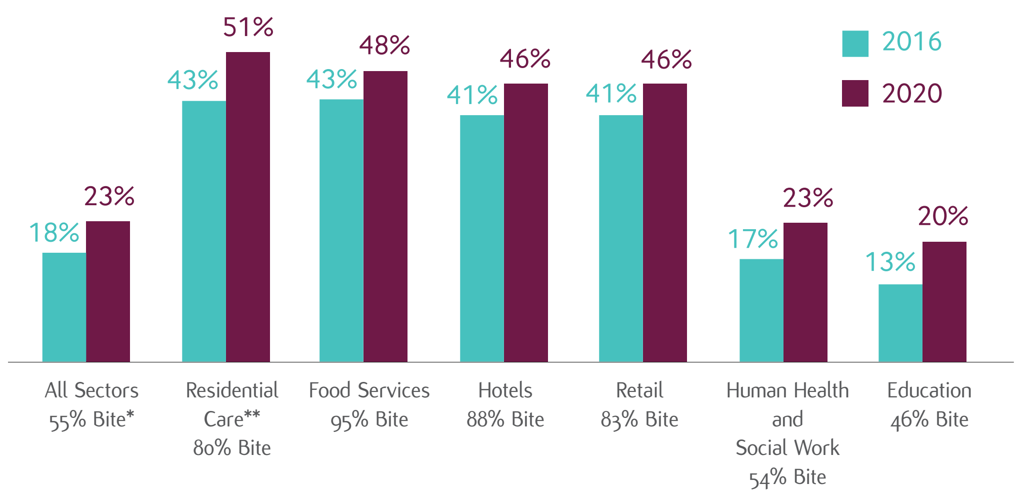


Source: The Resolution Foundation “Taking up the floor, exploring the impact of the National Living Wage on employers”

Questions

1. What are the concerns voiced over the impact of the NLW?
2. Have investors lost their deal appetite?
3. Are we seeing businesses pro-actively implementing cost mitigation strategies?
4. How can the different sectors accommodate the NLW and manage the change?

Share of employees affected by the NLW increase by sector in 2016 and 2020



*The Bite is the National Minimum Wage as a % of the Median salary across all employees of the industry, the higher the median salary, the lower the Bite %
** Residential care is included in the Human Health and Social Work

The National Living Wage fails to weaken the sector's positive mood

With close to 14,800 hotels and 680,000 rooms in operation, the UK hotels market is enjoying strong trading levels and 2015 is set to be a new record for deal activity with close to £10bn worth of transactions expected by the end of December 2015.

In this upbeat environment, the sector is powering through various external factors such as the Eurozone crisis and the growth of alternative accommodation providers but remains generally positive ahead of upcoming challenges such as the NLW, pension auto-enrolment and the business rate revaluation coming into effect in April 2017. Overall, the positive macro-economic climate and particularly the relatively benign inflation have mitigated the reaction to the NLW.

Interestingly, compared to other sectors, notably the care industry, except for some leading industry figures, the hotels sector has been somewhat slower to address the Chancellor's announcement on the NLW, even though employment costs are the biggest single cost for the sector and hotels are expected to witness the highest total wage increase by 2020.

Costs will increase significantly, as will employee satisfaction and retention

Whitbread - one of Britain's biggest employers and the leading hotel brand in the UK with Premier Inn - was the first hotel operator to publicly respond in September 2015, noting that over 80% of their workforce are currently paid less than £7.20 an hour and therefore will be impacted by this new measure. As a result of this sudden hike in wages, Whitbread confirmed that they are likely to scale back their recruitment plans and pass on some of the cost increases to their customers.

In their October results, Whitbread estimated that the NLW incremental payroll cost would be in the region of £15 to £20m per annum. However, this is only the tip of the iceberg as the NLW will indirectly impact other major cost lines, such as outsourcing and supplier costs, as they will also be looking to pass on their increasing costs to their customers - the hotels. Another factor not to be underestimated is that an upward shift in wages for the lower-paid employees will result in overall wage compression, subsequently putting pressure on management to increase salaries of employees not on the NLW to maintain some level of salary differential between employees.

The NLW will undoubtedly result in some job losses and scaled-back recruitment plans. It is also likely that squeezed bottom lines will constrain the ability of owners to invest in their assets through Capex.

On a more positive note, for an industry notoriously known for low salaries and long working hours, increased remuneration should lead to higher staff retention and improved morale, resulting in reduced dependency on expensive agency staff. In turn, this should result in lower recruitment and training costs, with enhanced staff productivity as well as consumer service.

Investor sentiment remains high, despite the uncertainty surrounding the NLW

With UK hotel investor sentiment at a high during 2015, the announcement of the NLW in July did not send immediate shockwaves through the hotels sector and many operators and investors initially adopted a 'head-in-the-sand' approach as they were keen to close deals.

However, in recent months, as the full impact of the NLW became more evident, this issue has started to lengthen due diligence processes, forcing sellers to revise their business plans and might partly explain the moderate transactional slowdown since the summer.

Smaller operators and independent owners represent those most likely to feel the pressure from the NLW as they do not have the operational flexibility and bargaining power of larger groups. We are therefore likely to see an upturn in distressed deal activity in the medium term, especially if the UK hotel cycle reaches a new downturn or an interest rate hike occurs.

Creativity will be required to mitigate cost impact

The obvious solution will be to pass on the incremental costs directly to the consumers, some of which will benefit from increased purchasing power with the NLW. Whilst this might be partly achievable in some price-elastic markets, our view is that operators ultimately will have to absorb some of the impact and be inventive to find alternative operational efficiencies, particularly if the macro-economic and hotel trading environments are not as favourable as currently.

Based on our ongoing discussions with operators and investors, most of them are now tackling this issue head on and drawing up contingency plans to not only estimate the impact on costs and thus returns, but also to identify saving

›› opportunities. Whitbread has detailed several mitigating actions to include productivity improvements, boosted by investment in systems and training, efficiency savings and selective price increases.

Overall, we believe it is essential that the impact of the NLW is carefully assessed on a case-by-case basis, as it will impact results to varying degrees depending on the location, positioning and operating structure of the asset under consideration.

"The NLW is another industry-wide issue for us to consider when assessing deals. We are still keen to pursue UK hotel acquisitions but as with every deal, the right level of due diligence has to be undertaken to assess risks and returns and potential saving areas".

Alex Ducharme, Acquisitions, Starwood Capital Group

OVER 50%

of hotel employees are low-paid

+3.4%

increase in hotel wage bills — the highest across all sectors

The Resolution Foundation

"It is important that hotel owners take a proactive approach to assess and plan for this sudden cost hike. As one of the leading hotel operators and owners in the UK, we have drawn up an inventive contingency plan which will mitigate the operational and financial impact on our business."

Jamie Lamb, CFO of Kew Green Hotels Limited

"80% of our workforce is currently paid below £7.20 an hour"

Whitbread

A recovering sector facing yet another hurdle

There are just under 50,000 pubs across the UK today, contributing £22bn towards the national GDP according to the British Beer & Pub Association (BBPA). After having been hit by higher taxes and stringent regulations, notably the smoking ban, which led to the closure of over 10,000 unprofitable units between 2006 and 2014 across the country, the sector outlook is brighter in the reshaped UK pubs industry.

According to the Resolution Foundation, the food and beverage sector has a significant proportion of low-paid employees (68%). When casting an eye down a profit and loss account for any business in the pubs sector, there is one item in the overheads section that clearly stands out — wages. Although these levels fluctuate from operation to operation, employment costs are by far the largest expense accounting for c. 25-30% of turnover.

The extent of the impact of the NLW will depend on local price elasticity

The Association of Licensed Multiple Retailers (ALMR) has conducted a survey of its members (1,812 outlets responded) looking into the impact of the NLW changes. The results show that 84% of staff are paid on an hourly basis and nearly 50% of those would receive pay increases as a result of the NLW. The increase in wages costs is unlikely to stop there, with those unaffected directly likely to benefit from salary increases to ensure pay equity.

The combination of pension auto-enrolment and the NLW will certainly have an impact on the sector and the extent will partly depend on the type of operator, and how prepared they are. With such a diverse offering within the sector there is no rule of thumb as to the impact, some operators will be able to pass the cost directly onto consumers but for those located in highly-competitive, price-sensitive areas, this may not be an option. Increasing prices will most certainly be a challenge for many of the major nationals who operate off lower margins to drive volume. Operators with more flexibility to increase prices will have to manage this carefully to avoid damaging their operating model and market share.

One of our business partners and major industry players shared their thoughts with Christie + Co on the NLW and raised a crucial point which is the age structure of the pubs industry. In their case, 65% of employees are below 25 and thus not eligible for the NLW.

Some investors accounting for the NLW miss out on deals

There has been a number of significant transactions within the sector since the publication of the National Living Wage Policy Paper in August 2015. The analysis of these transactions does not show any substantial impact of the NLW with improved multiples and comparable, if not improved market sentiment relative to the period before the announcement.

Currently, from a transactional perspective, prospective purchasers assessing deals do not appear to be factoring in future increases in employment costs. In fact, potential purchasers who are building upwards wage movements into their projections and subsequent offers are consequently missing out on deals.

It is too early to say if the news surrounding the NLW will have any impact on market sentiment or multiples being offered by buyers within local markets. Undoubtedly, as the changes come into force, operating profits will be affected, ultimately impacting on value. One of the possible consequences of business failures will be the increase in pubs being listed as Assets of Community Value (ACV), to protect them from change of use or demolition.

History shows that Capex and quality usually take the hit

Inevitably, margins are going to be squeezed and in the longer term, other actions will have to be taken to compensate for this, whether it is a reduction in staff or reduced investment in facilities. As history has shown, where margins are tight, less capital is allocated to repairs and improvements, which in turn impacts stock quality and the ability to push prices up. Suppliers will be facing a similar challenge to the pubs sector, with some passing the increased cost on to consumers and others taking on the burden. Independent operators are more likely to switch suppliers in order to find cost savings at any level. Overall, suppliers are bound to be challenged to share the burden with pubs and leisure operators, and some entertainment costs, such as Sky TV, are likely to be reduced.

Where businesses are unable to support the incremental cost pressure, we may see an upturn in distressed asset sales. Marginal public houses will be forced to close in the medium term, which will result in some job losses.

On a more positive note, in the case of well-prepared, quality businesses, this new measure will result in lower employee turnover and increased motivation of staff at the lower end of the pay scale. The current skills shortage in the industry may be corrected by this measure, ultimately leading to better service and supporting potential price increases.

PAYROLL:

25-30%

of pubs' turnover

50% of hourly-paid staff will be affected in the pub industry

The Resolution Foundation

"With economic and consumer confidence returning, there is a notably increased willingness to put up prices as a result of changes in cost base. This is perhaps because average wage rate inflation has for the last year outstripped CPI and RPI inflation, resulting in increased leisure spending, but also because businesses have less ability to accommodate increased labour costs. 65% of companies have put up prices as a result of NMW changes, more than doubling the 2014 figure of 31%. This has been a fluctuating metric throughout the recessionary period, highlighting the turbulence and fragility of the sector to external stimuli. In 2006, 85% of operators chose to put up prices to deal with the increase at the height of the recession between 2008 and 2010, between 15-20% of respondents felt able to do so. In 2011, that increased temporarily to 61% but fell back again last year to 27%. This further signals a fragile recovery."

National Minimum Wage – A Response from the Association of Licensed Multiple Retailers October 2015

68%

of F&B staff is low-paid

The Resolution Foundation

65% of companies have put up prices as a result of NMW changes

ALMR report

Simon Chaplin, Director and Head of Restaurants

A booming industry, yet constrained by high rents

The UK restaurants industry has seen substantial growth over recent years, becoming one of the most diverse “eating out” markets in the world, with around 330,000 venues producing an annual income of over £85bn. Equity-backed branded operators have been the driving force behind this success story but the independent sector still accounts for over 70% of the market from cafés to fine-dining venues.

Despite this positive environment, increase in sales has remained stubbornly below 5%, and in many cases, operators are reporting like-for-like growth rates of less than 2%. This is against a backdrop of increasing rents, especially in London and key cities around the UK which account for up to 20% of the sector’s income. This is a key risk factor in an industry, where almost 90% of operators hold leasehold property.

A complete rethink of the remuneration package in the restaurants industry

The introduction of the NLW coincides with a complete rethink of remuneration packages in the restaurants sector, with the tipping culture currently under scrutiny by the government. Tips have always been an essential component of any employment package offered to staff and many employers are already looking at ways to distribute them fairly while taking into account the NLW. Whilst the reliance of restaurants’ staff on tips is not as important as in the United States, it is interesting to note that leading New York operator Danny Mayer, who owns Shake Shack in the UK, is abolishing the service charge and tipping, paying his staff fairly for the work they undertake. Maybe this is a measure we will see introduced more widely in the UK in years to come, reducing the reliance by operators on the ‘discretionary’ 12.5% service charge.

Capex investment and large transactions still on the go

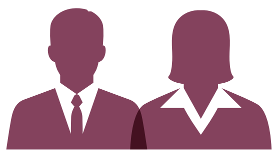
Whilst the news of the NLW was greeted with some disquiet by the restaurants industry, it does not seem to have affected the appetite for deals so far, with a number of larger branded operators changing hands and receiving investment for expansion since July 2015. Of course the full impact of the NLW has yet to be seen on the bottom line but most are preparing for it or have started to introduce it in readiness. Over the coming year, we may well see a levelling off in values in the independent market as the minimum wage and other costs, such as rent, rise. The forthcoming business rate revaluation will also hit the bottom line and there is little doubt that some businesses will fail as a consequence. With Central London seeing around 180 new restaurants open every year, yet 35% closing down, it remains a sword of Damocles for many.

Increasing prices set to be a challenge

An evident way to counter the increased wage bills is to raise prices, especially in a market where the dining out culture is thriving. However, recent surveys suggest that whilst frequency is growing, the average spend per head remains static, with the main driving factor being the under 25 age-group eating out at fast casual dining venues. Furthermore the discounted “voucher culture” has clearly diminished as operators have been struggling to maintain margins.

For larger corporate operators, they may be able to absorb the impact of the NLW while maintaining operating margins through stricter staff controls such as more zero-hour contracts, as well as portion control and menu pricing. Smaller independent restaurateurs are likely to face the greatest challenge, although in many cases, key staff have always been well looked after as good operators seek to retain quality employees to maintain continuity.

48%



of employees expected to be affected by the NLW in 2020

The Resolution Foundation

“The reality is that for most operators The National Living Wage is another cost burden on businesses which have already seen margins squeezed, mainly through increased property costs with rents soaring to record levels in the traditional prime restaurant locations. Restaurants cannot keep putting prices up, the mid-market sector is too competitive for that and the danger is that to keep margins operators may have to cut labour and look at new, more streamlined ways of running restaurants – more casual and less personal with more automated systems.

People forget that a lot of staff in the hospitality industry earn far more than the basic minimum wage via a share of service charge and tips – the real issue is perhaps that the Living Wage means an employee’s total pay is inflated beyond the value of some roles and to a level where for example a waiter is earning significantly more than a junior manager which then has a knock-on effect with wage demands further up the ladder. Restaurants provide great employment opportunities but to create more jobs through further expansion, restaurants need to be able to make sense of labour costs which work for the business as a whole and allow reasonable returns.”

David Solomon, HR Director of Property & Compliance, Maxwell’s Restaurants, Clubs & Bars, London

The 2016 NLW is expected to be 3% higher than today’s median salary across the restaurants industry

The Resolution Foundation

£85bn

annual revenue generated by the sector

The care sector faces the double trouble of nurse shortage and National Living Wage

Activity in the care sector has been very strong over the past two years with many new and very well-funded investors entering the market. Despite this overall positive mood, the NLW adds yet another cloud on the horizon in an industry where staff costs are the single biggest item of expenditure. Earlier this year, we published a report on the UK Nursing Workforce, which included a survey of the 12 largest nursing home operators (accounting for 30% of the UK market). The results of our survey show that over a three-year period, average staff cost expenditure increased from approximately 59.0% to 61.0% of revenue. Over the same period and due to a shortage of 15,000 nurses in the UK, reliance on agency personnel has also materially increased.

Unable to compensate by fee increases, the sector yearns for additional public funding

The introduction of the NLW is a key issue for the adult social care sector and elderly care in particular, given the significant number of staff currently remunerated at minimum wage levels. Unlike other Christie + Co sectors where operators have the ability to raise prices to offset the impact, the care sector is less able to do this as funding for care is, in the majority of cases, provided by local authorities which are grappling with central government austerity measures and funding constraints. Care homes with a high percentage of privately-funded residents are the notable exception to this general rule, although they make up a relatively small proportion of the overall market.

The National Audit Office states that local authority budgets have been reduced by nearly 40% in real terms over the last five years with statutory funding for social care decreasing by £4.6bn during the same period. This comes at a time when the UK population is getting older, living longer and suffering from a range of increasingly complex health conditions. Over the last five years, local authority fee rate increases have been nominal and in many areas, operating margins have been eroded as operators have had to absorb the impact of operating cost inflation or, where possible, to leverage privately-funded resident fee rates as a way of cross subsidising clients on much-lower local authority rates.

The UK's largest operator, Four Seasons Health Care, has publicly stated that the introduction of the National Living Wage will increase its staff cost expenditure by £10m in 2016. Based on an analysis of care homes which we have appraised this year, we estimate that net wages will increase by around 5% if pay rates for staff below the Living Wage level are increased to £7.20 per hour. This increases to nearly 10% if current wage differentials for more senior staff (excluding nurses, management and admin) are maintained. We have estimated that approximately £1.2bn of additional public funding would be required by 2020 to cover the cost of the NLW.

Intense lobbying in an apprehensive climate

Given the scale of the potential impact, there is a real concern in the industry that a number of homes will become unviable if the NLW is introduced without suitable compensatory fee rate increases. Local authorities are also under pressure as they have a legal obligation under the 2014 Care Act to cover the cost of care.

Operators and stakeholders from all segments of the sector have been proactively lobbying government. The recent round table discussion which was hosted by HealthInvestor and included participation by Christie + Co provides an excellent insight in terms of how the industry has been responding *(http://healthinvestorintel.com/media/1271/hinovroundtable_web.pdf).*

Too important to fail

In the absence of such clarity, there is an increasing amount of uncertainty at the corporate end of the market, which has impacted on some of the larger disposal processes. Purchasers are re-pricing their bids and sellers are evaluating whether to postpone sales processes until there is greater certainty on funding moving forward. However, it must be remembered that the care sector is needs driven. Ultimately a solution will have to be found given the high degree of reliance which is placed on the private sector to deliver a significant proportion of the residential care provision required to look after our ageing population. With many media reports suggesting that the NHS is beyond capacity and at breaking point, there is no real alternative available to government without the private sector playing a crucial role moving forward.

The Autumn Spending Review Statement: what it means for the care sector

From the care sector perspective, the key outcomes from the 2015 Autumn Statement are the possibility for local authorities to increase council tax by up to 2.0% a year to fund additional social care spending, as well as the £1.5bn to be added to the Better Care Fund by 2019-20 to fund the integration of health and social care.

›› Our initial analysis shows that based on current council tax levels and total local authorities adult social care spending, the 2.0% council tax increase could generate approximately £550m in extra funding next year, which could support fee increases of 4.2-4.6% on average. An important question, however, is how additional Public Care Spending will be distributed and how much will actually reach care home providers.

We believe that the 2015 Autumn Statement was encouraging for the sector although we acknowledge that many operators will remain cautious until there is clear evidence of this additional funding being delivered to front line providers. The foundation for the additional funding required to compensate for the NLW in 2016, however, has now been laid. Anything beyond 2016, including the impact of the Better Care Fund, remains very uncertain though.

2016 will bring clarity on the willingness and ability of local councils to address the issues head on. This will set the tone for the funding dynamics until the second stage of the NLW raise in 2020.

£550m

in potential extra funding for 2016 from social care precept on council tax

Funding for social care decreased by £4.6bn over the past five years

"We view the announcements of the Autumn Spending Review with cautious optimism. If the tax is fully raised next year, it could provide much needed compensation for the National Living Wage. The question really is when and how much of that spending will reach care home providers, given the competition for funds from the domiciliary care sector and local authority internal spending on care management and assessment. However, given the strong and long-standing relationships between residential care providers and local authorities, I am optimistic that the extra funding will be provided at least to those high quality operators who need and deserve it."

Dr Pete Calveley, CEO of Barchester Healthcare

£1.2bn

of additional public funding would be required by 2020 to cover the cost of the National Living Wage

A highly-regulated, sought-after business sector, largely dependent on a "young" female workforce

The day nursery workforce is widely referred to as under-paid, in comparison to alternative careers in broadly equivalent roles in schools, notably teachers and teaching assistants. Children are our most valuable assets, and as such, all operators strive to give every child the best possible start by developing high-quality facilities, led by an experienced, skilled, motivated and passionate workforce. The cost of childcare generates recurrent debate, and while many operators are eager to better remunerate their staff, the shortfall in funding provided by local authorities is one of the major reasons why salaries paid in the nursery sector have remained broadly lower than for other care and teaching professions. Levels of salary expenditure across nursery businesses vary significantly, broadly ranging from 55% to 70% of revenues, dependent upon the location of the business, its operating capacity and occupancy, as well as the hourly funding rates awarded by each local authority – which in many cases are not sufficient.

The primary concerns voiced in relation to the introduction of the NLW are that increased wage costs will inevitably have to be passed on to parents through fee increases. The nursery operators that we have spoken to are willing to mitigate such burden for parents; however, while there continues to be a shortfall in local authority funding, the alternatives appear limited. Our recent discussions with prominent UK operators indicate that nursery fees will increase between c. 4% to 6%, however evidence gained by the National Day Nursery Association (NDNA) suggests that fee increases may need to be closer to 10% in order to meet the costs of the NLW.

Investors still have appetite for high-quality assets

Despite the planned introduction of the NLW, we have not seen a slowdown in deal activity and the market for high-quality day nurseries has remained incredibly strong. Indeed, we have witnessed higher transaction volume and pent-up demand during 2015, well ahead of previous years. Whilst deal appetite remains strong, a degree of cautious optimism is noticeable amongst prospective buyers, who are factoring in the potential impact of the NLW when assessing opportunities, as well as the potential fee increases that each business intends to implement to offset the increased wage costs.

In summary, for many of the projects in which we are involved, a cost-neutral position is anticipated.

There has been much discussion about when operators intend to increase childcare fees. Some have already applied substantial increases in September 2015, keeping with their annual fee increase terms, while others are currently notifying parents of proposed increases in early 2016. It is understood from the Spending Review and Autumn Statement that the average hourly rates for funded two-, three- and four-year olds are not to take into account the NLW increases. Should the NLW not be reflected in hourly rates awarded by local authorities, this would potentially push fees further with such incremental cost to be ultimately borne by parents.

Preparation is key

While we are seeing some businesses proactively implementing cost-mitigation strategies, such as comprehensive spending reviews of their own businesses, other operators appear less prepared and thus potentially at risk of impacting profit margins. In addition to hot topics such as capital expenditure, food and resource purchases, as well as debates around business rates, staffing ratios have now come into the spotlight again. There has been much ink spilled in relation to ratios around the findings of both the Government's Childcare Funding Review and a research report on the cost of delivering the early education entitlement, which were published on the same day as the Spending Review and Autumn Statement. This reminded us that qualifying settings are able to operate on a 1:13 staffing ratio where provision is graduate-led (level 6 or higher), rather than the more widely-accepted 1:8 ratio, which could have a positive impact on staffing expenditure.

Levels of salary costs range from

55%-70%

of revenues in day nurseries

"NDNA's vision is for a highly-qualified, well-trained workforce for UK nurseries. In April, the National Living Wage will be the biggest overhaul for payrolls since the minimum wage came in 16 years ago. We are keen for our staff to be properly rewarded and better pay leads to greater levels of motivation and engagement. Initially, it will mean an estimated 10% rise in payroll costs, with a much larger financial burden to follow. Nursery employers' hands are tied by current low levels of funding. Some of this cost will have to be passed on to parents in the form of fee increases. The Chancellor has allocated £300m more to the childcare sector in his Spending Review, equating to about 30p more per child per hour in England. But, all that money needs to get through to the frontline where it's badly needed and also keep pace with rising costs. We are calling for this money to be ring-fenced at local authority level to prevent "top-slicing" and for similar funding to be received by all childcare providers."

Purnima Tanuku OBE, Chief Executive of National Day Nurseries Association

Qualifying settings are able to operate on a 1:13 staffing ratio rather than the more widely-accepted 1:8 ratio

Initial indications suggest 80,000 jobs may be at risk in the retail sector

There are currently over 51,500 convenience stores across the UK, employing 407,000 staff and contributing £37.7bn in sales to the UK economy. Convenience stores are rated by consumers and local governments as being the second most positive high-street service behind Post Offices, many of which are housed in convenience stores.

Despite some critical industry-wide changes, such as the rise of online shopping and self-checkout, the retail sector remains a labour-intensive industry and will be amongst the sectors most impacted by the introduction of the National Living Wage according to the Resolution Foundation. According to the Association of Convenience Stores (ACS), the cost of the NLW across the whole sector will be in the region of £166m and is likely to put 80,000 jobs at risk.

Room to absorb further costs for corporate

A recent study by business valuers and consultants, Pinders, estimates that a large convenience store with an annual turnover of £1.6m will witness an increase in staff costs ranging from 7% to 10% depending on the proportion of its workforce on the NLW. A small convenience store with a turnover of £420,000 per annum will see their wage bill increase by 10%, which is significant for a business with an estimated net profit of only £28,000 per annum. 40% of retailers feel that they will have to pass on the costs to shoppers through price increases.

Corporate operators in the convenience sector will be able to 'absorb' the extra costs more easily than smaller operators, which make up 75% of the convenience market. In the wake of the announcement, 40% of independent retailers have already cut back on investing in their business in order to mitigate the added cost pressure on their business. However, this is not always the case, as the ACS reports that more than a quarter of all convenience stores are family-run. This should give the incentive to these family-owned and operated stores to increase investment, as they will not have to worry about the NLW as much as others.

It's all about convenience

Shopping format options are broadening and consumers are embracing the range on offer. Such an evolution has seen the 'discounters' market flourish and take market share away from the major corporates, which have been dominating the marketplace for so long. According to a recent study by retail research expert IGD, sales from convenience stores, discount retailers and the internet will overtake supermarkets and hypermarkets by April 2019. The convenience grocery market is just that; convenient. Shoppers in this market could perhaps spend marginally more on their trips to their local store. However, we are unlikely to witness a major uplift in sales, as convenience shopping is a necessity to consumers who are shopping on a top-up mission. This consumer behaviour enables the convenience grocery market to be somewhat less inelastic than other retailers, which is expected to save this market just like it has in the past, during the recession.

No retrench in deal appetite seen to date

It is still a little early to draw definitive conclusions on deal appetite as a result of the NLW however the recent release of 100 small C-stores and CTN's by McColl's Retail Group has resulted in a huge amount of interest from owner-operators. This demonstrates that news surrounding the NLW does not appear to have impacted smaller businesses, where the owner works in the shop and has a small, if any, wage bill.

We have not seen any slowdown in the appetite of the large Multiples to acquire or develop new convenience stores. It is likely that multiple retailers will simply make a wage adjustment commensurate to the NLW in their financial modelling when formulating an offer for a business. Time will tell whether this has any effect on the level of pricing for businesses being transacted.

Corporates gear up for the National Living Wage while the convenience market is less apprehensive

The convenience market is not reliant on discretionary spending and we therefore have little reason to believe the sector will see financially-distressed cases as a direct result of the NLW. The growth in convenience shopping is driven by consumer behaviour and there are no signs of this letting up in the short to medium term. These two factors should provide investors with the confidence to remain active in the sector going forward.

Despite this, job cuts in the wider grocery sector are imminent as supermarket operators address their cost base. Some major operators are already tackling cost increases through other means. For example, Tesco have introduced Project Reset, in an attempt to decrease the number of stock-keeping units in their stores and help narrow their product line to reduce cost of sales. Tesco are also reducing trading hours at selected locations as the extra late hours were unsustainable. Morrisons have recently sold their convenience arm, as they felt this was not profitable enough to maintain.

›› Overall, the convenience market is set to face many challenges, other than the NLW, in the upcoming months. Uncertainty around the future of business rates remains following the Chancellor's Autumn Statement 2015, where he announced that rate setting powers were to be devolved to local authorities. There was also no conclusive rate reform meaning businesses need to start planning effectively for the future. Overall, we expect to see dynamics of the convenience grocery market change in the coming year and even more so after the Budget announcements in 2016.

c.20%

of jobs in the convenience grocery retail sector estimated at risk – 80,000 jobs

The ACS

"We have to accept the need to pay people a living wage... once we accept that, we then need to work out how to make that work. The government needs to work with employers to find realistic levels and achievable timescales. That said, the only way that I believe C-stores can survive increasing salary levels is to get better at, and grow, fresh and food to go so that margins can afford the ability to pay higher levels in the future."

Mike Greene, CEO of My Local

"The impact of the living wage is material to the growth development of the convenience sector. It is important to put money in the pockets of our store team. They are crucial to the future prosperity of the business. We favour a continued increase in the tax threshold and changes to the benefits system to give workers more, rather than passing the burden to individual retail owners."

Debbie Robinson, Managing Director of Spar UK

46% of staff to be affected by the NLW by 2020

The Resolution Foundation

40%

of retailers feel that they will have to increase the cost of products

Simon Hughes, Director and Head of Medical

Higher-paid staff will mitigate the NLW impact

The medical sector has proven to be very strong through 2015, generating unabated investor appetite in the UK. In this positive environment it seems that there is no initial apprehension ahead of the NLW introduction, which is partly explained by the fact that relatively few employees in this particular industry are on low wages.

The remuneration structure in the dentistry and pharmacy sectors is very different from other sectors covered in this publication, being less labour-intensive with a much smaller proportion of low-paid staff. Since the NLW announcement, we have consulted with many pharmacy and dental operators who have confirmed they are aware of the forthcoming legislation although corporate operators seem much more attuned to the likely implications for their businesses than independent practices.

Overall, the NLW introduction has not deterred prospective buyers and general investor sentiment remains very high in the medical sector.

Whilst the sector will cope with the NLW, it is facing more pressing threats

Most operators view the NLW as a concern, not in the short term but in the longer term – particularly if combined with the anticipated squeeze on NHS funding thus increasing overheads and further reducing profit margins.

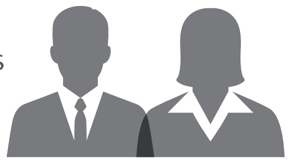
Their main area of concern is that the NLW will create demand for greater wage increases throughout the business and that this is viewed as a much bigger risk than the NLW itself. Most operators flagged pension auto-enrolment as a more direct threat to their businesses than the NLW.

Human Health and Social Work industry wage bill forecast to rise by less than 1%

ONLY

17%

of Human Health and Social Work employees to be affected by the NLW in 2016



Chris Day, Managing Director

Whilst the implementation of the NLW will undoubtedly create some challenges across our sectors, it would appear that most operators are pro-actively tackling it and drawing up inventive plans to limit the impact on their businesses. In our opinion, it will also create a range of opportunities in the medium term, both on the operating and transactional sides.

With the UK workforce close to full employment, salary increases are inevitable and better remuneration will improve staff retention, service quality and ultimately customer satisfaction. Higher disposable income should lead to increased consumption and greater spending power, which will directly benefit most of our sectors, especially in light of the current low inflationary environment and the positive macro-economic backdrop.

In most instances, operating margins should have enough cushion to absorb the impact and quality operators will find innovative ways to offset the impact. It is likely that corporate operators will undergo strategic reviews of their estates and poorer performing units will come out of the corporate sphere and return to the individual sector. Family-run businesses should be the prime beneficiaries as they run more flexible business models and they will be able to remove the layer of corporate costs, thus boosting operating margins.

As clearly evidenced by the number of buyers registered on the Christie + Co website, there is a ready market waiting for such acquisition opportunities. Since the beginning of the year, we have seen increases of over 20% in active potential buyers and over 40% in unique users, this demonstrates the pent-up demand for independent businesses across the Hospitality, Care, Childcare, Convenience Retail and Medical sectors. The anticipated level of returns and motivation factors of private buyers will allow them to see opportunity where corporate operators see unsustainable businesses.

In our view, competent quality operators in both the corporate and individual sectors will weather the storm. Anticipation is essential and well-prepared companies will find ways to mitigate the impact either through economies of scale or innovative solutions.

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