WAREHOUSE WIN-WIN:

ACHIEVE HIGHER WAGES AND LOWER COST WITH VARIABLE COMPENSATION

"I can't get enough people in the building to staff my operation.
How can I keep asking the ones who *do* show up to work to produce more?"

Thoughts like these have kept retail and distribution leaders up at night over the past 18 months. Two competing factors are to blame:

- **Talent shortages make hiring and retaining reliable and effective hourly employees a growing challenge.**
- **Pushing the employees who show up to produce more can feel incongruous with a positive workplace environment. It risks creating an even larger attrition and talent shortage problem than existed in the first place.**

While these factors may seem in conflict, **variable compensation programs** offer a solution for both. When designed well, these programs bolster employee performance and morale while driving down overall labor costs—a win-win for workforce- and resource-strapped distribution leaders.

THRIVING IN A COMPETITIVE LABOR MARKET WITH HIGH PERFORMERS

The COVID-19 pandemic introduced conditions in almost every aspect of our lives that would have been unimaginable just two years ago. Today's hourly labor market is no exception. Businesses are navigating higher wages,[1] battling elevated turnover, bearing the cost of increased overtime, and toying with creative incentives. All of this adds up to a daily struggle to meet the needs of customers.

Retail and distribution employers initially responded to the labor market squeeze by raising base hourly wages to stay ahead of the curve and drive retention. Many of these employers are now forced to think outside the box, offering aggressive retention bonuses[2] and other incentives to keep employees on the payroll and showing up for work regularly.[3]

[1] "Walmart Gives Workers a Raise and Weighs in on the Minimum Wage Debate," Retail Wire, Feb. 19, 2021.
[2] "Walmart Gives Warehouse Workers Bonuses and Pay Raises to Keep them from Quitting," Insider, Aug. 6, 2021.
[3] "Walmart to Offer Bonuses to Keep Warehouse Workers on the Job Through the Holidays," CNBC, Aug. 6, 2021.

These approaches have substantial limitations. They're reactionary to short-term requirements and add significant costs to the bottom line. And, in the end, they offer no incremental benefit to productivity; organizations simply absorb these costs to keep products flowing to customers.

Retail and consumer products organizations need to instead look for sustainable solutions. The best ones will enable companies to maintain a top-tier workforce, cost effectively, in a volatile, unpredictable market.

Automation and variable compensation programs are two of the best avenues to sustainable solutions. We've observed that many supply chain organizations rightly foray into the complex and capital-intensive world of process automation. While valuable, these programs disrupt existing operations, and it often takes several years to recover the investment. For a more immediate return on your labor dollar, we recommend also tapping into variable compensation.

THE COMPELLING WIN-WIN POTENTIAL OF VARIABLE COMPENSATION

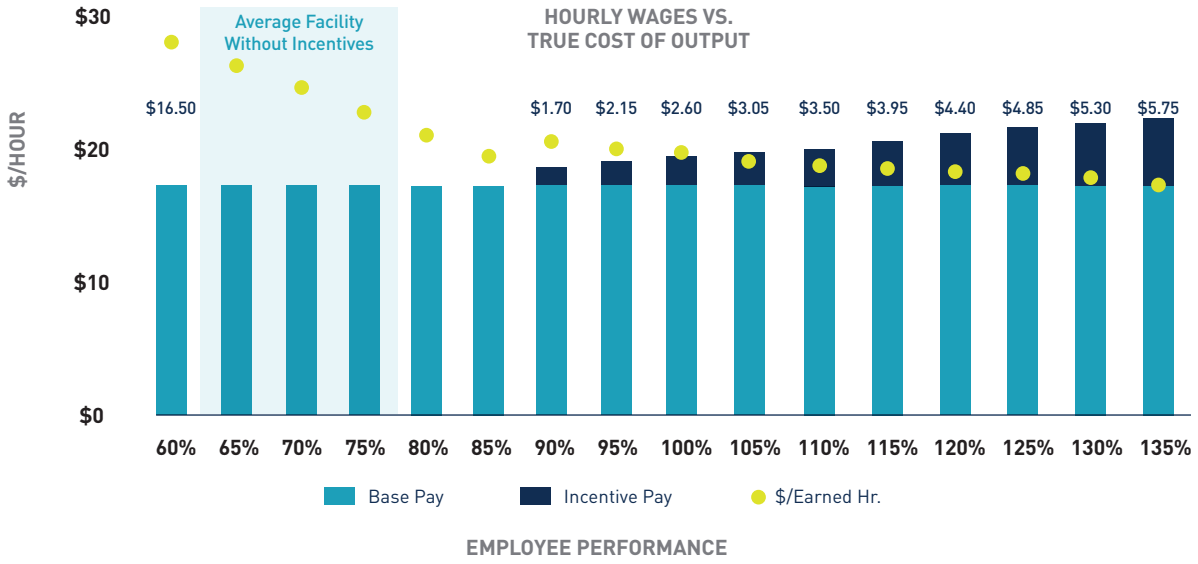
In the world of productive direct labor, many management teams expect high performance from their teams and enforce that expectation with negative consequences. This approach rarely succeeds in abundant labor markets. In today's environment, it fails completely while also increasing the risk of negative publicity.

To understand why, let's look at the incentives. For employees who are compensated hourly, there's no incremental payoff for producing above the norm. In non-incented environments, our experience shows that employees typically make effective use of about 60 to 65 percent of their time. Management's typical response is to periodically raise and enforce the minimum productivity requirement to improve performance, but this approach drives a wedge between leaders and their productive teams. From the workers' perspectives, the increase in requirements often seems arbitrary. They perceive it as a "just work harder for the same wages" message handed down from management. That negative perception increases turnover, which lowers overall productivity. The vicious cycle repeats.

There's a better way: variable compensation based on individual employee productivity. Variable compensation is a proven, positive motivational approach. When done correctly, it creates a highly desirable overlap between an organization's top-paid hourly employees and those that cost the least per unit of production.

Variable compensation programs typically keep the base (guaranteed) hourly wage unchanged, so new and lower-performing employees are not negatively affected. Employees can earn incentive bonuses at a certain level of performance. From there, the hourly rate increases with performance, removing the limit from top performers' earning potential. The math behind this approach is simple once you define labor cost as dollars per hour of standard work accomplished, instead of average wage per hour of time worked.

Here's a variable compensation structure we designed to help one client navigate today's challenging labor climate:



Each bar represents one hour of labor costs, based on an employee's wages and performance. The teal bar is the base wage, and the navy blue bar is the additional incentive earned per hour, which increases with higher performance. The cost for an earned hour of work (represented by the yellow dots) is calculated by multiplying an employee's hourly earned wage by the number of hours it takes for the employee to complete an hour of standard work at 100 percent performance. This true cost of output is much more important than an employee's actual hourly wage. The actual cost for an hour of earned output is higher for lower performers, because they're paid for more hours to accomplish the same amount of output that a higher performer can complete in fewer hours.

Without incentives, driving average performance above 80 percent is difficult, and it typically requires a draconian approach to performance management. Getting your variable compensation program right calls for a careful balance of art and science. You'll need to create an incentive curve that sufficiently motivates the individual to perform and simultaneously lowers the overall labor cost for an hour of productive output. This win-win scenario should be the goal of any direct labor organization that wants to reduce costs and better retain its most productive employees.

Regardless of your organization's performance management maturity, the technology required for a variable compensation program is robust and accessible. We've seen dramatic improvements over the past 10 years in the ability to track individual performance based on multiple factors related to the work done. These Labor Management System (LMS) tools are the lifeblood of an effective variable compensation program. While they require significant effort and investment to set up accurately, they typically pay dividends much more quickly than other technological and automation enhancements.

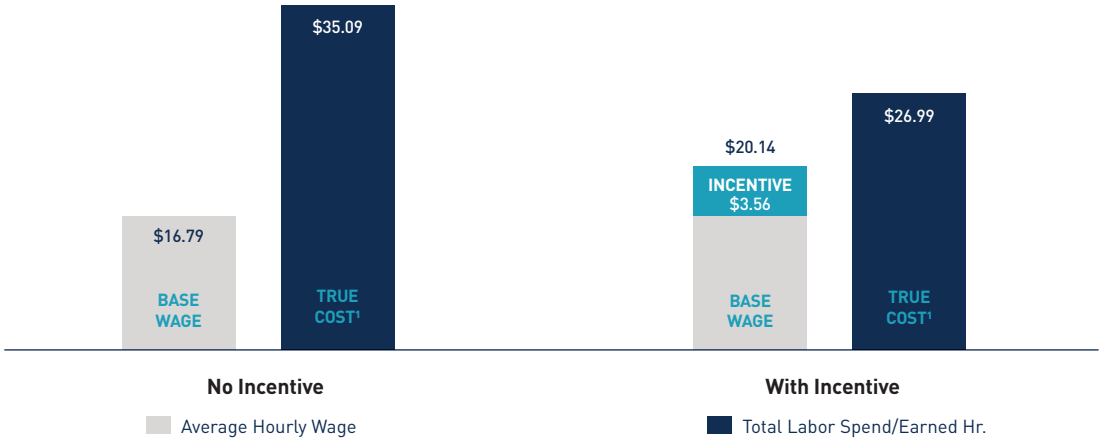
Here's The Key Takeaway:
As performance increases, the cost per earned hour comes down, while pay increases to incentivize and recognize the higher productivity. From our experience, this monetary incentive is critical to driving down the average cost of an hour of productive output. We see this trend play out in the chart: The yellow dots, representing the true cost for an hour of output, continue to decline even as the employee is making an additional four to six dollars per hour on top of the base wage.

BECOMING A TOP-TIER DIRECT LABOR ORGANIZATION IN A VOLATILE CLIMATE

Those responsible for the management of direct labor employees would love nothing more than to be both a low-cost operation and one that pays wages well above the local prevailing rate. Luckily, this future is achievable with individual incentives. They're often the key final ingredient for top-tier direct labor organizations.

As illustrated in the chart below, one of our clients realized a substantial benefit after introducing individual incentives to one of its most demanding operational areas. Average employee pay is up 20 percent, with top performers earning $150 to $200 more per week. Overall, the average cost of producing an hour of standard work is down over 20 percent. Best of all, outcomes like these represent the norm across our clients—not the exception.

ASSOCIATE HOURLY PAY VS. TRUE COST
(WAREHOUSE PILOT EXAMPLE)



[1] Includes costs for taxes, benefits, PTO, breaks, and non-productive time.

In our experience in today's competitive environment, the average operation pays about $30 to $40 for an hour's worth of standard output, while top-tier operations pay their employees on average 10 to 20 percent more per labor hour. At the same time, they enjoy a lower cost per unit of output—typically about 10 to 20 percent less per unit.

In addition to bottom-line savings, variable compensation programs can propel a distribution organization to top-tier status by enabling it to:

- **Offer top-tier local wages for high-performing entry-level labor.**
- **Reduce the supervisor effort required to maintain a minimal level of performance.**
- **Immediately and continuously recognize employee effort and contribution, improving morale and performance.**
- **Remove barriers to success.**
- **Achieve the same level of production with 20 to 25 percent lower headcount.**
- **Reduce turnover among top performers.**
- **Reduce hiring, onboarding, and training costs.**
- **Create a strong performance culture—and maintain it as new employees are hired.**

WHAT IT TAKES

To get started, make an intentional decision to reward individual performance and pursue labor savings. From there, recognize that the process takes time and a steadfast commitment to success—just like any transformational change. Along the variable compensation journey, consider the following essential steps to make high performance business as usual.

- **Properly install and configure a Labor Management System (LMS) with multivariable standards.**
- **Develop accurate and stable engineered standards, applying engineering time studies.**
- **Design incentive curves that encourage high performance and lower overall labor costs.**
- **Garner leadership sponsorship and supervisor support for the program.**
- **Craft straightforward program details that educate the workforce and build alignment.**
- **Configure robust performance reporting and posting. (Pro tip: This is usually most effective when designed outside of the LMS with BI reporting tools.)**
- **Design flexible and straightforward incentive calculating tools that are supported by a repeatable process. (The right BI tool can support this, too.)**
- **Redesign payroll processes to deliver bonuses to employees in every payment cycle.**
- **Onboard engineering support to maintain the accuracy of standards post-implementation (approximately one for every 600 full-time employees).**

With a variable compensation program, you'll likely start to see your culture transform in material ways as employees' attitudes, behaviors, and mindsets evolve to support high performance. By keeping employees engaged and motivated through the promise of compensation tied to individual performance, you will be well-positioned for gains in retention, productivity, and cost-savings—and ultimately a sustainable path forward in today's volatile labor climate.

LET'S CONTINUE THE CONVERSATION

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Seth is a Master Practitioner at North Highland. He has more than 20 years of experience in the supply chain industry, with 12 years in management consulting and eight years in industry. Specific areas of his expertise include supply chain strategy, labor optimization, continuous improvement, deep analytics, and change management.

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ABOUT NORTH HIGHLAND

North Highland makes change happen, helping businesses transform by placing people at the heart of every decision. It's how lasting progress is made. With our blend of workforce, customer and operational expertise, we're the world's leading transformation consultancy. We break new ground today, so tomorrow is easier to navigate.

Founded in 1992, North Highland is an employee-owned firm—regularly named one of the best places to work. We have more than 5,000 consultants worldwide and 65+ offices around the globe. Meanwhile, we're a proud member of Cordence Worldwide (www.cordence.com), an international consulting alliance.
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