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Foreword

A new year is an opportunity for renewal—a fresh start, a time to recommit to long-standing goals or to pursue new ones, a chance to get reenergized and build momentum for the year ahead. Indeed, most of my recent conversations with leaders in the retail and consumer-goods industries have been about bold plans to tackle the challenges and make the most of the opportunities that this year will bring.

As you embark on your 2019 journey, my colleagues and I offer some of our latest thinking on topics that affect retailers and consumer-goods manufacturers worldwide. We find this to be a time like no other, as large-scale trends and disruptions fundamentally and systematically reshape the consumer sector. The articles in this edition of *Perspectives on retail and consumer goods* explore how these trends and disruptions are changing our industries, and how successful companies are responding to—and capitalizing on—these changes. We hope that our research and analyses will help you gain new insights, find inspired solutions, and learn from the experiences of others.

Some recurring themes emerge in many of these articles. One is the potential of digitization and advanced analytics to transform every part of the business. Another is the rising importance of agility in organizations—the ability to act rapidly on customer feedback, bring solutions to

market quickly, and refine them continuously. Yet another is the crucial role that talent plays in a company's success, in a world where certain skills and capabilities are in extremely high demand but short supply.

Companies neglect these themes at their peril. In every subsector within retail and consumer goods, we've found that the winners are those companies that harness the power of digitization and analytics, implement agile methodologies, and put talent at the top of the CEO agenda. We believe that laggards in these areas might get by in the short term but will be vulnerable in the medium term—and ultimately will struggle to survive.

This edition of *Perspectives* also features an interview with Kevin Ozan, the CFO of McDonald's. As part of the top team at one of the world's largest restaurant chains, he has firsthand knowledge of what it takes to turn around a company in decline and steer it toward sustained, profitable growth. McDonald's has been one of the most fascinating growth stories in the retail and food-service industry in the past few years. I hope you find the interview both interesting and instructive.

On behalf of my colleagues at McKinsey, I wish you a happy and prosperous 2019.

Greg Kelly
Senior partner, Atlanta

Winning in an era of unprecedented disruption:
A perspective on US retail

In light of the large-scale forces disrupting the US retail industry, once-optional moves have become imperatives.

Jess Huang, Sajal Kohli, and Shruti Lal


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Much has been made lately of the "retail apocalypse," with headline after headline declaring the demise of retail as we know it. Yes, store closures have indeed outpaced store openings across the US market in recent years. And, yes, retail foot traffic in both mall stores and stand-alone stores has been, and continues to be, on a downward trajectory. It's also true that the retail landscape is littered with bankruptcies—upward of 40 in the past two and a half years in North America alone, with more looming on the horizon.

Yet, at the same time, Amazon and other digital disruptors had a massive run-up in share in a slew of retail categories. Brands are getting into the retail game themselves and going directly to the consumer. The pace of M&A and private-equity activity in the sector has quickened in recent months. Perhaps most telling of all, US retail sales have actually risen: the 2017 total of $3.53 trillion is a 3.9 percent increase from 2016.

So, is traditional retail dead? Or is it undergoing a metamorphosis—and more alive than ever?

In our view, the answer is clear: the US retail industry, far from being moribund, is experiencing disruption—and reinvention—at unprecedented speed. It's not a story about the malaise of an entire sector but rather a tale of two worlds. A confluence of trends has changed the playing field, forcing retailers either to adapt and innovate or to suffer painful losses or imminent demise.

In this new playing field, consumers are promiscuous in their shopping, easily switching from one brand or channel to another. Technology not only drives consumer engagement but also changes the playbook for retail productivity. Industry boundaries are blurring: nonretailers are selling to consumers, while retailers are expanding into adjacent sectors in pursuit of growth. The war for talent rages on, and retailers are battling companies both inside and outside retail to attract the best people. And, of course, other large-scale risks and uncertainties—new trade tariffs and cyberthreats, to name just two—are keeping many a retail CEO up at night.

If there was ever a time to challenge assumptions and take bold action, it is now. In the face of this disruption, formerly optional moves have become "must dos." Retailers that sit on the fence risk getting outcompeted by aggressive, fast-moving, forward-thinking competitors.

In this article, we discuss five disruptions and five imperatives for competing in the retail environment of the future. While a few retailers may be ahead of the game in one or more of the imperatives, none are yet excelling in all of them.

A disruption like no other: Key questions to ask now

Although many of the trends we discuss have been evident for several years, the certainty, combination, and acceleration of these forces have resulted in a disruption unlike any that retailers have faced before. This is the new normal.

Are you meeting consumers where they are—both physically and digitally?

Gone are the days when a retailer could rely on brand loyalty. Recent surveys have found that millennials tend to perceive newer brands as better and more innovative, and that more than 60 percent of Gen Z consumers are attracted to smaller "new" and "fun" brands. Many younger consumers, who want brands to be transparent and approachable, say they distrust large corporate brand names. Being an older, well-established brand name—once a major asset—is now something of a liability.

Against this backdrop, retailers and consumer brands must work harder to engage consumers—and the most effective way to do so is via digital media.

Customer relationships are now digital-centric, with consumers spending, on average, almost six hours per day on digital media. Digital channels continue to be the source of most retail growth and will soon influence most retail purchases: Forrester Research estimates that by 2022, e-commerce will account for 17 percent of total retail sales (ranging, by category, from 4 percent in grocery to 66 percent in electronics), while an additional 41 percent will be digitally influenced offline sales (with digital channels influencing as much as 30 percent of offline sales, even in mostly offline categories like grocery).[1]

The shift to online sales, coupled with rising labor costs, puts pressure on store economics. At best, the economics are break even; at worst, a 5 percent shift from in store to online can reduce earnings before interest and taxes (EBIT) by 20 to 30 percent. At the same time, the "buy online, pick up in store" option, now offered by many retailers, boosts store traffic. Retailers must therefore evaluate store economics within the broader context of omnichannel economics.

Consumers' embrace of digital media has also made retail competition more intense: savvy upstart brands can quickly gain a foothold online, even bypassing traditional retail channels. E-commerce platforms, such as Shopify, have enabled value and luxury brands alike to launch direct-to-consumer sites without making big investments in tech capabilities. Smaller brands can market themselves inexpensively yet effectively on the internet and on social networks. These innovative brands selling directly to consumers also further reinforce the idea that traditional retailers are stale, as they don't carry these new brands.

Another effect of digitization: consumers now have sky-high expectations when it comes to convenience. They've become accustomed to near-instant gratification: on-demand movies and music, speedy delivery of online orders, and even smart devices that can purchase items automatically. For all retailers, this means having to ensure a convenient, frictionless shopping experience both offline and online. A retailer's accessibility and relevance are no longer just about physical location but also about digital presence, whether through mobile sites and apps (their own or others') or smart devices in cars and homes.

Are technology and analytics working for you?

Digitization is revolutionizing not just how retailers engage with consumers but also how they unlock productivity. Whereas scale was once the primary lever of cost and efficiency, technology now plays that role across the value chain. In-store retail technologies, from handheld devices to sensors, are improving store processes. Robotic process automation is speeding up back-office tasks. Retailers have access to more operational data than ever, can conduct sophisticated analytics, and can tap into artificial intelligence (AI) to inform everything from product design to supply-chain management to store experience.

Our research suggests that currently available, at-scale technology could help automate more than 55 percent of tasks in a classic grocery store. This automation would reduce selling, general, and administrative (SG&A) costs; enhance customer and employee experience; and free up funds to fuel growth elsewhere. Furthermore, research from the McKinsey Global Institute has shown that the retail industry could reap global benefits from AI worth $400 billion to $800 billion—more than any other industry. Such advanced technologies were once too expensive and unproven, but their economics now work.

At the same time, there are dramatic business implications that retailers will need to grapple with. For example, with more processes and information being digitized, cybersecurity becomes ever more critical. Yet, only 16 percent of global organizations believe their risk-management processes are mature enough to handle cyberthreats.[2]

How will you compete with the nonretailer retailer?

Many retailers aren't just retailers anymore—they've expanded into services, healthcare, and other adjacent sectors. Target acquired delivery-focused companies Grand Junction and Shipt, CVS Health acquired health insurer Aetna, and IKEA now owns TaskRabbit. Conversely, nonretail companies are encroaching on retailers' turf. Fitness companies like Peloton are selling products, such as exercise bikes and athletic apparel, as well as experiences and technology.

China's Alibaba, JD.com, and Tencent—and, following their lead, Amazon—became online juggernauts precisely by crossing industry boundaries. These pioneer companies created ecosystems that integrate marketplaces, services, platforms, and digital content. In the US market, Amazon is a retailer as well as an e-marketplace, a web-services provider, a producer of movies and TV shows, a maker of smart-home devices, and an online pharmacy, among other things. As these cross-industry ecosystems capture an ever-larger share of consumers' time and attention online, they'll easily grab more and more market share.

Are you positioned to win the war for talent?

To win in this era of disruption, retailers can no longer rely on the traditional talent profiles; they need to hire the would-be disruptors. This means acquiring new skills, including data science, software development, and advanced analytics. And as retailers expand into becoming service and experience providers, they'll also need expertise in new industries.

Finding best-in-class talent is tough, not least because retailers are competing with direct-to-consumer companies, energetic start-ups, and tech giants—all of which tend to be more appealing to the most in-demand talent profiles. Even the hottest retail brands may not be perceived as desirable

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employers, as they're tainted by the retail industry's reputation of being old fashioned and slow. An additional challenge for retailers is that talent is concentrated in the major coastal cities.

Another facet of the war for talent, both at the front line and in corporate offices, is the potential displacement and necessary reskilling of retail workers, driven by the advent of AI and automation. In our view, this should be the number-one obsession of chief people officers and heads of HR in retail. They will need to get ahead of it before competitors, regulators, or public-opinion shapers force the issue.

Are you prepared for the local impact of global risks?

With a number of emerging-market companies experiencing supercharged growth, it's no surprise that they're looking to expand beyond their home countries and even their home continents. Retailers with global aspirations—including Alibaba and JD.com—are eyeing the US market as their next target for expansion.

Meanwhile, on the global stage, much remains in flux. The level of uncertainty and volatility surrounding global trade is higher than it's been in recent years, with new tariffs, changes in several countries' trade agreements, new data-privacy rules and regulations, and geopolitical developments all across the globe. For most retailers in the Western Hemisphere engaged in offshore sourcing, geopolitical forces could fundamentally reshape the P&L.

No longer optional: Key actions to take now

To survive and thrive in the coming decade, retailers must refashion their businesses to capture the opportunities presented by the totality of these trends. For many retailers, it's now do or die. Operational discipline will be more critical than ever, as retailers will need to find funds to fuel these transformations. Here are five imperatives—not suggestions—for companies that aim to be tomorrow's retail winners.

Reimagine the store

Since established brand names mean much less to consumers than they used to, the basis of retail competition is shifting from price and product superiority to privileged insights and customer experience. In light of this shift, there's no doubt that physical stores can still be highly effective consumer touchpoints, but retailers need to think hard about the role of the store.[3] Stores must be tightly integrated with the online channel, enabling online sales while simultaneously offering experiential features and cutting-edge technology that sets the store apart.

Nike does an admirable job of marrying in-person experiences with digital capabilities in its stores. At the company's flagship store in midtown Manhattan, customers can use the Nike app to reserve products for pickup, scan QR codes on mannequins to check for available colors and sizes, pay for merchandise instantly, and book in-store consultations with Nike experts. Another New York City store, in the SoHo neighborhood, boasts athletic environments—such as a basketball half-court and a treadmill—enhanced with cameras and digital screens to give shoppers an immersive experience and real-time feedback.

Because convenience has become increasingly important to consumers, retailers should deploy technology that makes shopping easy and seamless. Food retailer Ahold Delhaize's no-checkout "tap to go" technology is one example. Apparel retailer Everlane allows customers who have registered on its website to "shop walletless" in its stores. At the New York and San Francisco stores of the apparel brand Reformation, customers use digital screens to select items they want to try on; store associates then place the items in dressing rooms.

Sweat your tech and analytics spend

Technology and advanced analytics represent massive opportunity in retail. Advanced analytics should inform retailers' decisions across the value chain—from targeted pricing and promotions to smarter category management and localized assortment planning. In back-office functions, analytics and machine learning can increase efficiency and effectiveness, reducing cost to fuel efforts on more strategic priorities.

Personalized marketing, in particular, can unlock enormous value: retailers have seen sales uplift of 10 to 30 percent and as much as 5 percent improvement in customer acquisition. Using advanced analytics, retailers can monitor customer "signals"—such as purchases, online browsing, and social-media posts—which should then trigger relevant and timely personalized messages. And retailers shouldn't wait for perfect systems or perfect data to get started cultivating real-time relationships with individual consumers. Although one-to-one personalization is the goal, even one-to-many is better than no personalization at all.[4]

There's much higher scrutiny today, from both inside and outside companies, on resource allocation and returns on tech spending, but the right investments

> The basis of retail competition is shifting from price and product superiority to privileged insights and customer experience.

can pay off handsomely. Retailers that are technology leaders can generate two to five percentage points greater EBIT than technology laggards.

Pursue partnerships as a new way to compete

Witnessing the seemingly unstoppable growth of retail ecosystems like Alibaba and Amazon, traditional retailers are realizing that they can't go it alone, because of both capability gaps and the sheer financial burden of keeping up with technology cycles. Some retailers have joined forces with companies in other industries, allowing them to amass consumer touchpoints, gather new consumer data and insights, or access capabilities they couldn't otherwise afford. Examples include Kroger partnering with UK-based Ocado to build 20 automated warehouses in the next three years, several grocers linking up with delivery service Instacart, and McDonald's working with Uber Eats to offer food delivery from thousands of McDonald's restaurants around the world.

Retailers should also seek to establish consumer touchpoints within the large ecosystems: Alibaba, Amazon, Google, JD.com, and Tencent. For example, several retailers—including Carrefour, H&M, and Walmart—have formed partnerships with Google. (Recognizing their outsize influence, even the ecosystems themselves are partnering with each other. Amazon has a storefront on Alibaba's TMall. Google and Tencent announced a long-term agreement to share patents. Tencent has an ownership stake in JD.com.) Retailers must determine what they bring to the table in both data and capabilities and how to integrate such partnerships into their strategy.

If retailers have the cash and capabilities, they could perhaps create their own ecosystems. Consider the following scenario: a drugstore chain partners with a health insurer, a chain of fitness centers, a physician-referral service, and a health-focused tech company, like Fitbit. Such an ecosystem would offer a single, comprehensive network for a consumer's health and wellness needs. Part of this strategy should be a reimagination of the retail business model: for instance, the ecosystem might offer rentals, subscriptions, ad space, or digital goods, all of which hold significant potential as new revenue streams and new ways of reaching customers.

Become an agile, talent-first organization

Because speed is at a premium, agility must become a way of life for retailers. There are, of course, SG&A benefits associated with organizations implementing flatter structures with flexible networks of teams, but agility is about so much more. Agile companies are three times faster at going from ideation to implementation and two times more likely to take bold risks to transform the customer experience.[5] For retailers, becoming agile means moving away from the heavily matrixed organizations and meeting-driven cultures of the past and instead forming small, cross-functional teams that use "concept sprints" to design, test, and scale initiatives.[6]

Just as essential as agility is an organization-wide emphasis on talent. What does it mean for a retailer to put talent first?[7] Practically, it means coming up with a new value proposition for attracting and retaining a new breed of retail employees. It means looking for candidates in nontraditional places, including the so-called gig economy, in which 20 to 30 percent of the US working-age population already participates. Retailers must create a culture for new talent profiles to succeed in the organization and offer creative options and approaches (such as virtual working environments) to support different ways of working. Some retailers, including Target and Walmart, have opted to secure needed capabilities through "acqui-hiring," or acquiring start-ups primarily for their talent. Retailers must also develop strategies for reskilling and retraining the workforce.[8] Simply put, company leaders must be convinced of—and then act on—the fact that without the right people and the right skills, success just won't be possible.

Take a 360-degree view of risk

With disruption comes uncertainty, and retailers must ensure they can respond rapidly to fast-changing circumstances. Take the issue of tariffs: if new tariffs on Chinese imports materialize, a company that is heavily reliant on Chinese manufacturing could suffer devastating financial consequences. Retailers face a broad range of other risks as well, including brand and reputation risk, activist investors, cyberattacks, and data-privacy breaches. Yet a recent McKinsey survey of more than 1,100 global companies found that boards spend less than 10 percent of their time on risk management—a percentage that hasn't increased in the past few years.[9]

It's critical for retailers to cultivate strong risk-identification and risk-management capabilities and to create and prepare for a variety of scenarios systematically; taking lessons from the banking sector could be one idea.[10] And retailers must develop strategies for data protection and digital resilience, the hallmarks of which include an engaged and aware frontline staff, differentiated protection for the most important assets, and active defenses that can be deployed in real time.[11]

■ ■ ■

Retail is in the midst of a disruption like no other, which is forcing an existential crisis. Every retailer must decide whether or not to get ahead of the curve and redefine its strategy and operating model to win in this era of disruption. Some are taking a wait-and-see stance; others are moving too cautiously and making little impact. But there are real costs to waiting that may never be recoverable. Only by heeding the imperatives discussed in this article—and acting with urgency—can retailers position themselves for a winning future. ■

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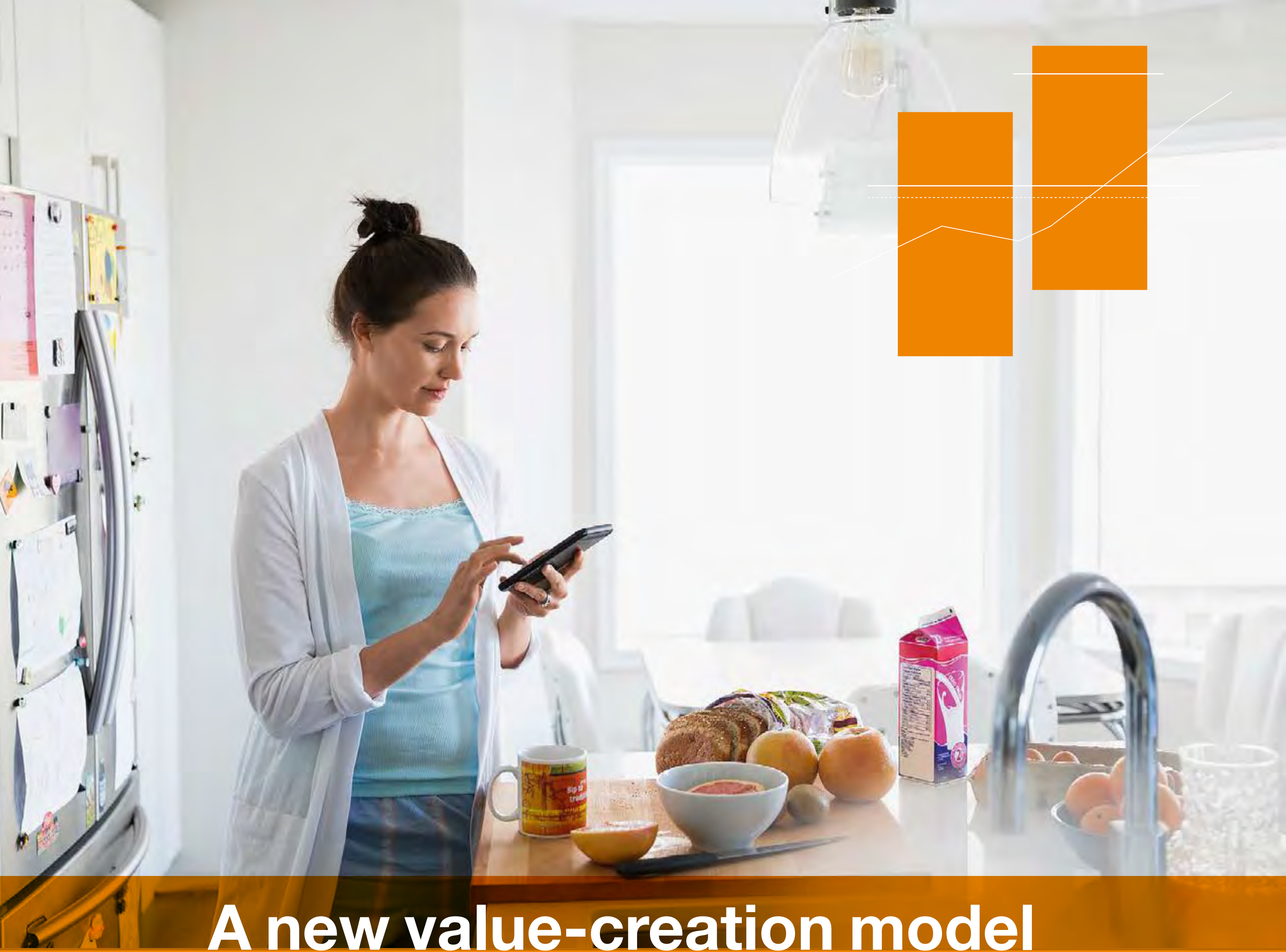
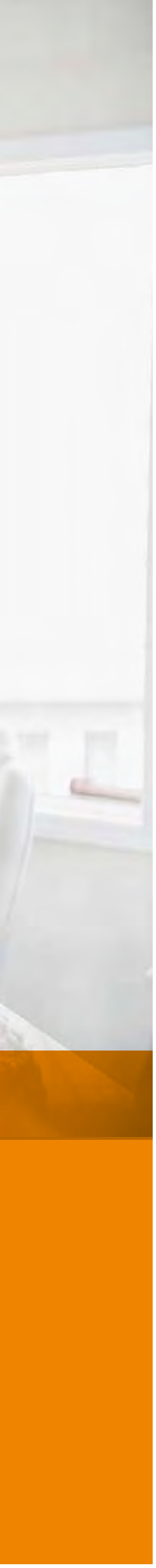


A new value-creation model for consumer goods

The industry's historical value-creation model is faltering. Here's how to reinvent it.

Greg Kelly, Udo Kopka, Jörn Küpper, and Jessica Moulton



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The fast-moving-consumer-goods (FMCG) industry has had a long history of generating margin-enhancing growth. By 2010, the industry had created 23 of the world's top 100 brands and had grown total returns to shareholders (TRS) almost 15 percent a year for 40 years. But the model that fueled industry success now faces great pressure as consumer behaviors shift and the channel landscape changes.

To win in the coming decades, FMCG companies must reduce their reliance on mass brands and offline mass channels. They must also embrace an agile operating model focused on brand relevance rather than synergies.

The traditional model

FMCG companies owed much of their success to a five-part model for creating value. Pioneered just after World War II, the model has seen little change since then. FMCG companies did the following:

- *Perfected mass-market brand building and product innovation,* thus capturing not only reliable revenue growth but also gross margins typically 25 percent above those of nonbranded players.

- *Built relationships with grocers and other mass retailers that provide advantaged access to consumers.* By partnering on innovation and in-store execution and tightly aligning their supply chains, FMCG companies secured broad distribution as these retailers grew.

- *Entered developing markets early and actively cultivated their categories.* Consumers in developing markets became wealthier and proved a tremendous source of growth—generating 75 percent of revenue growth in the sector over the past decade.

- *Designed their operating model for consistent execution and cost reduction.* Most FMCG companies have increased centralization to continue pushing costs down. This synergy-based model has kept general and administrative expenses at 4 to 6 percent of revenue.

- *Used M&A to consolidate markets and create a basis for organic growth postacquisition.* After updating their portfolios with new brands and categories, FMCG companies applied their superior distribution and business practices to grow those brands and categories.

Signs of stagnation

But this long-successful model of value creation has lost considerable steam. The household-products subsegment, for example, has dropped from the sixth most profit-generating subsegment at the start of the century to the tenth, measured by economic profit. Food products, long the most challenging FMCG subsegment, fell from 21st place to 32nd. As a consequence, FMCG companies' TRS growth lagged behind the S&P 500 by three percentage points from 2012 to 2017. As recently as 2001 to 2008, their TRS growth beat the S&P by 6 percent a year.

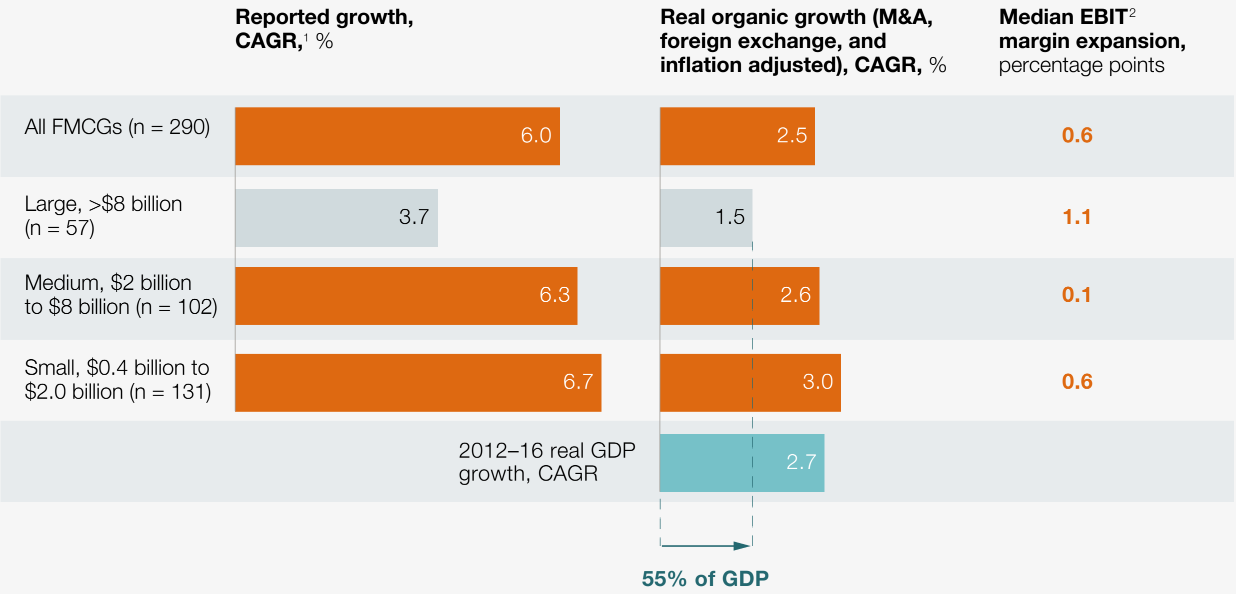
The issue is the lack of organic growth. From 2012 to 2015, the FMCG industry grew organic revenue at 2.5 percent (net of M&A, foreign-exchange effects, and inflation), slightly behind global GDP growth. But companies with more than $8 billion in annual revenue grew at only 1.5 percent—half the growth rate of companies with sales of under $2 billion (Exhibit 1). This difference suggests that large companies face a serious growth penalty, which they are not making up for through their minor earnings-before-interest-and-taxes (EBIT) expansion.

Organic growth matters in the consumer-goods industry. FMCG companies that achieve above-market revenue growth and margin expansion generate 1.6 times as much TRS growth as players that outperform only on margin.

Exhibit 1

Organic fast-moving-consumer-goods (FMCG) industry growth has been weak, with large companies growing at only 55 percent of GDP.

2012–16 performance of FMCG companies larger than $400 million in net revenue



[1] Compound annual growth rate.
[2] Earnings before interest and taxes.

Source: World Bank; McKinsey analysis

Ten disruptive trends

This FMCG value-creation model stopped generating growth because of ten technology-driven trends, most of which are in their infancy but will have significant impact on the model within the next five years (Exhibit 2).

1. The millennial effect

A recent McKinsey survey found that millennials are almost four times more likely than baby boomers to avoid buying products from “the big food companies.” And while millennials are obsessed with researching before buying, they resist marketing and look instead to learn about brands from one another. They also tend to believe that newer brands are better or more innovative, and they prefer not to shop in mass channels.[1] Furthermore, millennials are much more open to sharing personal information, allowing “born digital” challenger brands to target them with more tailored propositions and with greater marketing-spend efficiency. Millennials are generally willing to pay for special things but otherwise seek value. Millennials in the United States are 9 percent poorer than Gen Xers were at the same age, so they have much less to spend and choose carefully what to buy and where to buy it.

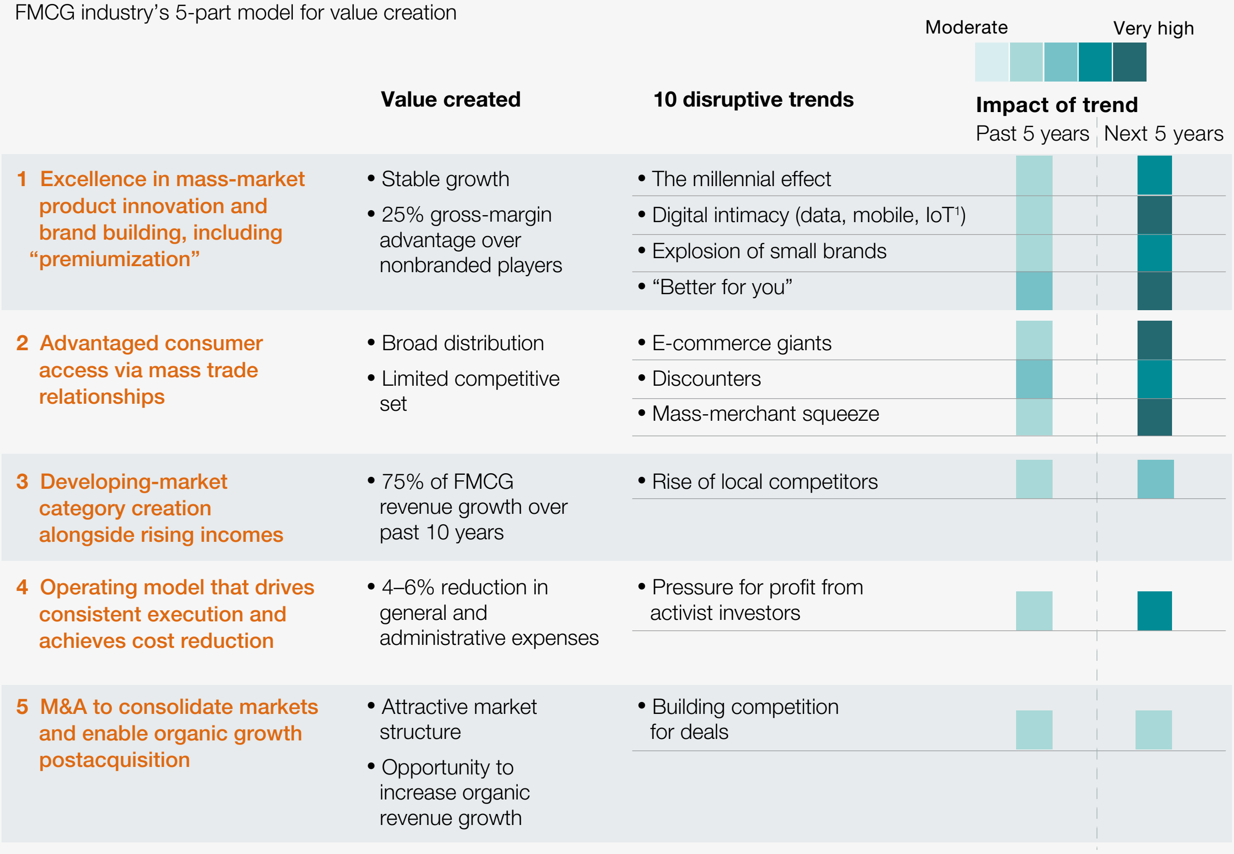
2. Digital intimacy (data, mobile, and the Internet of Things)

The volume of data generated continues to increase, boosting companies’ capabilities but also consumer expectations. Most FMCG companies have started to embrace digital but have far to go, especially in

Exhibit 2

Ten trends are disrupting the historical value-creation model in the fast-moving-consumer-goods (FMCG) industry.

FMCG industry's 5-part model for value creation



Moderate ■■■■■ Very high

FMCG industry's 5-part model for value creation	Value created	10 disruptive trends	Impact of trend Past 5 years	Impact of trend Next 5 years
1 Excellence in mass-market product innovation and brand building, including "premiumization"	• Stable growth • 25% gross-margin advantage over nonbranded players	• The millennial effect	■	■
		• Digital intimacy (data, mobile, IoT[1])	■	■
		• Explosion of small brands	■	■
		• "Better for you"	■	■
2 Advantaged consumer access via mass trade relationships	• Broad distribution • Limited competitive set	• E-commerce giants	■	■
		• Discounters	■	■
		• Mass-merchant squeeze	■	■
3 Developing-market category creation alongside rising incomes	• 75% of FMCG revenue growth over past 10 years	• Rise of local competitors	■	■
4 Operating model that drives consistent execution and achieves cost reduction	• 4–6% reduction in general and administrative expenses	• Pressure for profit from activist investors	■	■
5 M&A to consolidate markets and enable organic growth postacquisition	• Attractive market structure • Opportunity to increase organic revenue growth	• Building competition for deals	■	■

[1] Internet of Things.

adopting truly data-driven marketing and sales practices. Some FMCG categories, particularly home care, will be revolutionized by the Internet of Things (IoT)—converting some product needs, like laundry, into service needs. And in many categories, the IoT will reshape the consumer decision journey, especially by facilitating automatic replenishment.[2]

3. Explosion of small brands

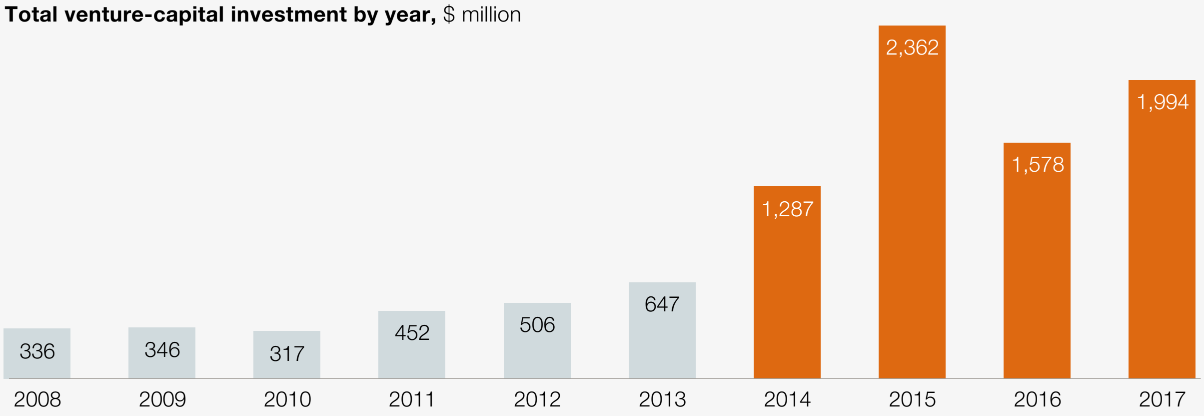
Many small consumer-goods brands are capitalizing on millennial preferences and digital marketing to grow rapidly. These brands can be hard to spot because they are often sold online or in channels not covered by syndicated data. But venture capitalists have spotted them: more than 4,000 of them have received $9.8 billion in venture funding over the past decade—$7.2 billion of it in the past four years alone (Exhibit 3).

Retailers have also taken notice of these small brands. According to Nielsen, US retailers are giving small brands double their fair share of new listings. Small brands can be a source of differentiation for retailers and can help drive

Exhibit 3

The venture-capital industry is fueling the explosion of small brands, providing $7.2 billion in investment in the past four years alone.

Total venture-capital investment by year, $ million



Example companies	Bai Banu Beyond Meat Brad's Raw Foods Brandless	Caulipower Daily Harvest FEED Projects Green Park Snacks Health-ade	Hello Beverages Impossible Foods Just Kensington and Sons Kite Hill	Koia KRAVE Jerky Memphis Meats	Spindrift Sugarfina Unreal Brands

Source: Pitchbook Data; McKinsey analysis

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margins, as these small brands tend to be premium and rarely sell their products at less than full price. As a consequence, they are capturing two to three times their fair share of growth while the largest brands remain flat or in slight decline (Exhibit 4).

Five factors make a category ripe for disruption by small brands: high margins, strong emotional engagement, a value chain that is easy to outsource, low shipment costs as a percent of product value, and low regulatory barriers. The beauty-products category fits this profile especially well. In color cosmetics, born-digital challenger brands already represent 10 percent of the market and are growing four times faster than the rest of the segment. The explosion of small brands in beauty enjoys the support of significant venture-capital investments—$1.6 billion from 2008 to 2017, with 80 percent of this investment since 2014. Digital marketing is fueling the growth of challenger brands while lifting the rest of the category as well. An astounding 1.5 million beauty-related videos are posted on YouTube every month, almost all of them user generated.[3]

4. “Better for you”

For years, consumers have said they want to eat healthier foods and live healthier lifestyles, but only recently has their behavior begun to change. Consumers are redefining what healthy means, eating more fresh food instead of packaged food, and demanding more products that are natural, organic, and free from sugar, gluten, pesticides, and other additives.

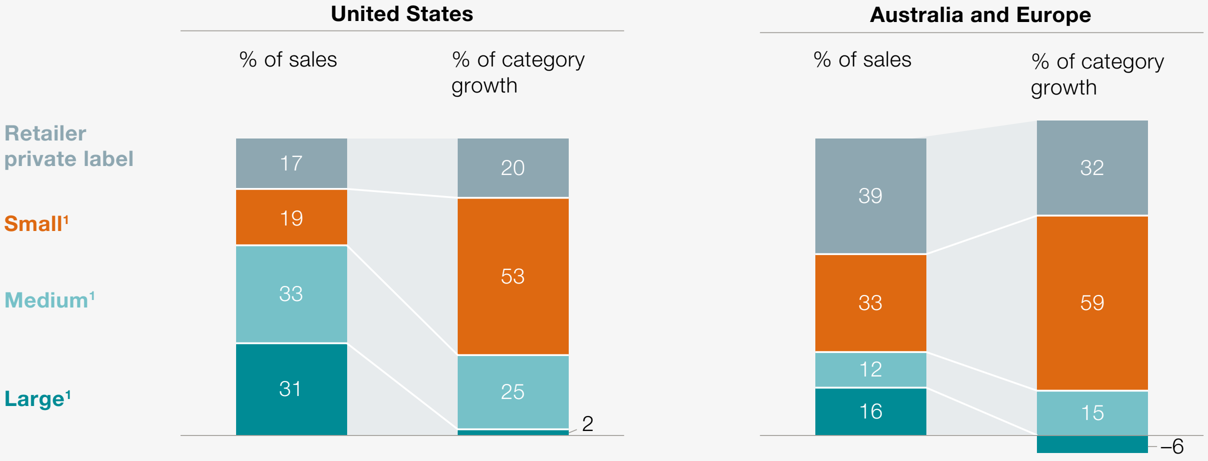
5. E-commerce giants

Alibaba, Amazon, and JD.com grew gross merchandise value at an amazing rate of 34 percent a year from 2012 to 2017. They are having a profound impact on consumer decision journeys across categories, forcing FMCG companies to rewrite their channel strategies and channel-management approaches, including how they assort, price, promote, and merchandise their products. In markets besides China, this disruption

Exhibit 4

Small companies are generating two to three times their fair share of growth in developed markets.

Fast-moving-consumer-goods industry share of sales and of growth, 2016–17



[1] “Large” refers to top 16 companies, “medium” to next 400 companies, and “small” to remaining companies.

Source: Retail Measurement by Nielsen

is still in its early days and will only accelerate as the e-commerce giants expand their geographic reach and move in to brick-and-mortar locations. Amazon's push on private labels is a further game changer.

6. Discounters

In each grocery market discounters enter, they typically grow to secure market share of 20 percent or more. Aldi and Lidl have grown at 5.5 percent between 2012 and 2017, and they are looking to the US market for growth. Discounters lure consumers with their carefully curated offering of approximately 1,000 fast-moving SKUs sold at prices 20 percent below mass grocers—and can still generate healthy returns.

7. Mass-merchant squeeze

Together, the seven largest mass retailers saw flat revenue between 2012 and 2017. This pressure is forcing mass merchants to become tougher trading partners: they are pursuing more aggressive procurement strategies, including participating in buying alliances; being more vigilant about SKU proliferation; and decreasing inventory levels. As mentioned, they are also seeking out smaller FMCG brands and strengthening their private labels.

8. The rise of local competitors

Developing markets still have tremendous growth potential. They are likely to generate new consumer sales of $11 trillion by 2025, which is the equivalent of 170 P&Gs. Local competitors will fight aggressively for that business by offering locally relevant products and acquiring local talent. FMCG companies will need to respond by moving away from their fairly centralized decision-making models. Local relevance, proximity to the consumer, and speed will become more important drivers of competitive advantage than consistent execution. Furthermore, channels in developing markets are evolving differently than they did in the West: discounter-like formats are doing well in many markets, and mobile will obviously continue to play a critical, leapfrogging role. This will require FMCG companies to update their go-to-market approaches.

9. Pressure for profit

Driven by activist investors, the market now has higher expectations for spend transparency and reallocation of resources. Large FMCG companies are implementing cost-reduction approaches such as zero-based budgeting, which typically reduce spend on activities such as marketing. While effective at increasing short-term profit, such approaches haven't yet proved their ability to generate longer-term winning TRS.

10. Increasing competition for deals

Certain consumer-packaged-goods sectors—such as over-the-counter drugs—will see greater competition for deals, as large assets become scarce and private-equity firms provide more and more funding and drive up valuations. M&A will therefore continue to be an important capability for growth.

Creating value in a reshaped marketplace

To survive and thrive in the coming decades, FMCG companies will need a new model for value creation—consisting of a three-part portfolio strategy as well as organizational and operational agility (Exhibit 5).

A broader portfolio strategy

Going forward, FMCG companies will need to sustain excellence in developed markets, even as they build the capabilities to leapfrog in developing markets and to "hothouse" premium niches.

Sustaining excellence in the developed-market base

FMCG companies must keep the base healthy. The good news is that the industry keeps advancing functional excellence through better technology and, increasingly, use of advanced analytics. The highest-impact advances we see are in the areas of revamping media spend, particularly through programmatic M&A and a deeper understanding of

Exhibit 5

The new model is a three-part portfolio strategy enabled by an agile organization, with continued use of M&A as an accelerator.

3-part portfolio strategy

1 **Excellence in the developed-market base**	2 **Leapfrogging in developing markets**	3 **Hothousing premium niches, scaling each to its greatest potential**
Relentless focus on innovation that generates incrementality	Bringing best technologies to market early	Innovation based on rapid test and learn
Daily excellence in execution, including use of advanced analytics	Market leadership in digital and mobile	Targeted digital marketing
	Local market autonomy	Full use of channels, including retailer e-commerce and direct to consumer
Joined-up sales approach that wins with omnichannel mass and e-commerce giants		Supply capability adapted to small runs and shipments

Agile operating model

4 **Agile organization: dynamic front end, stable backbone**

Semiautonomous agile teams				
Digital and IT capability	Data and advanced analytics capability	Mass supply system	Niche supply system	Back-office functions

5 **Continued use of M&A as an accelerator to drive market consolidation and fuel organic growth postacquisition**

return on investment; fine-tuning revenue growth management with big data and tools such as choice models; strengthening demand forecasting; and using robotics to improve shared services.

Companies will need to increase their pace of testing and adopt a "now, new, next" approach—ensuring that they have a pipeline of sales-stimulating incremental innovation (now), efforts trained on breakthrough innovation (new), and true game changers (next).

Furthermore, they will need to join up their historically decentralized sales function and overcome channel conflict. E-commerce must be treated as part of the core business. Players like Koninklijke Philips that have weathered the laborious process of harmonizing trade terms across markets are finding that they can grow profitably in e-marketplaces.

Finally, FMCG companies will need to keep driving down costs through zero-based budgeting,[4] highly automated "touchless" supply-chain and sales-and-operations planning, and advanced analytics and digital technologies to improve manufacturing performance (for instance, through predictive maintenance).[5] Many of these changes will require companies to treat technology as a core competency rather than a cost center.

Leapfrogging new category creation in developing markets

FMCG companies must bring their newest and best innovation, not lower-quality products, into developing markets early to capture a share of the $11 trillion potential growth. Success will require excellent digital execution, as many of these markets will grow up digital; empowerment of local leadership to make marketing decisions; and a route to market that is unified across offline and online channels.

Hothousing premium niches

To capitalize on the explosion of small brands, FMCG companies must identify and cultivate premium niches that have attractive economics and high growth potential. They must acquire or build small businesses and help them reach their full potential through fit-for-purpose commercialization and distribution. This means, for example, building a supply chain that produces small batches and can adapt as companies learn from consumers. The beauty industries' incubators are a good model here.

This three-part portfolio strategy calls for an agile organization. Agility allows a company to adapt to fast-changing circumstances.

An agile organization

Building an agile organization requires abandoning the traditional command-and-control structure—in which direction cascades down from leadership to middle management to the front line—in favor of viewing the organization as an organism that consists of a network of semiautonomous teams.[6] In this model, the role of leadership isn't "order giver," but rather enabler or "servant leader."

An agile organization has two essential components: the dynamic front end and the stable backbone.

The dynamic front end consists of small, cross-functional teams ("squads") that work to meet specific business objectives. The teams meet daily to prioritize work, allocate tasks, and review progress; use regular consumer and customer feedback loops; and coordinate with other teams to accomplish their shared goals.

The stable backbone provides the capabilities that agile teams need to achieve their objectives. The backbone includes clear rights and accountabilities, expertise, efficient core processes, shared values and purpose, and the data and technology needed for a simple, efficient back office.

The agile organization moves fast. Decision and learning cycles are rapid. Work proceeds in short iterations rather than in the traditional, long stage-gate process. Teams use testing and learning to minimize risk and generate constant product enhancements. The agile organization employs next-generation technology to enable collaboration and rapid iteration while reducing cost.[7]

M&A as an accelerator

M&A will remain critical to FMCG companies as a way to pivot the portfolio toward growth and improve market structure. The strongest FMCG companies will develop the skills of serial acquirers, becoming adept at acquiring both small and large assets and at using M&A to achieve strategic goals—redefining categories, building platforms and ecosystems, getting to scale quickly, and accessing technology and data through partnership. These companies will complement their M&A capability with integration and scaling capabilities, such as incubators or accelerators for small players.[8]

Moving forward

To respond to the changing marketplace, FMCG companies should take the following steps:

- *Take stock of your health by category in light of current and future disruption, and decide how fast to act.* Ask questions about the external market: How—and how much—are consumers changing? How well positioned are we to respond to these changes? What are the scale and trajectory of competitors that aren't tracked by syndicated data? Are our growth and rate of innovation higher than these competitors'? How advanced are competitors on making model changes that might represent competitive disadvantages for us? How healthy are our channel partners' business models, and to what degree are we at risk? Do our future plans take advantage of growth tailwinds and attractive niches? Answering these questions creates the basis for developing scenarios on how rapidly change will happen and how the current business model might fare in each scenario.

- *Draft the old-model-to-new-model changes that will position the company for success over the next decade.* This is the time to develop a three-part portfolio strategy and begin the multiyear transformation needed to become an agile organization, perhaps by launching and then scaling agile pilots. This is also the time to determine which capabilities to prioritize and build. Change management and talent assessment (to determine where hiring or reskilling are needed) will be critical.

- *Develop an action plan.* The plan should include an ambitious timeline for making the needed changes. It should also specify steps for recruiting the talent required for successful execution.

■ ■ ■

FMCG companies should proceed with these efforts with controlled urgency. They will need to make ever greater use of the consumer insights, innovation expertise, and activation capabilities that have led the industry to success—but companies must wean themselves away from reliance on the strategies and capabilities of the traditional value-creation model. It's time to adopt a new model. ■

This article is adapted from "The new model for consumer goods," which first appeared on McKinsey.com in April 2018.

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[1] For more on millennials' shopping habits, see Sangeeth Ram, "Meeting millennials where they shop: Shaping the future of shopping malls," January 2017, McKinsey.com.

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[6] Oliver Bossert, Alena Kretzberg, and Jürgen Laartz, "Unleashing the power of small, independent teams," *McKinsey Quarterly*, July 2018, McKinsey.com.

[7] Wouter Aghina, Aaron De Smet, Gerald Lackey, Michael Lurie, and Monica Murarka, *The five trademarks of agile organizations,* January 2018, McKinsey.com.

[8] Rebecca Doherty, Oliver Engert, and Andy West, "How the best acquirers excel at integration," January 2016, McKinsey.com.

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EXCERPT

Agility@Scale: Capturing growth in the US consumer-goods sector

To compete more effectively in the US market, consumer-packaged-goods companies must combine greater agility with new types of scale advantage.

Jan Henrich, Ed Little, Anne Martinez, Kandarp Shah, and Bernardo Sichel

This is an excerpt from “Agility@Scale: Solving the growth challenge in consumer packaged goods,” which first appeared online in July 2018. To read the full article, visit McKinsey.com.

It’s been a tough few years for large consumer-packaged-goods (CPG) manufacturers in the US market. Since 2011, the organic-growth rate for CPG companies has declined, with the decline continuing in 2018. CPG companies with material portions of their business in the United States have seen year-over-year organic-growth rates drop to the very low single digits on average. The length and depth of this decline isn’t something that the sector has experienced over the past 20 years or more, and the drop contrasts with consumer confidence, which is back up at prerecession levels (Exhibit 1).

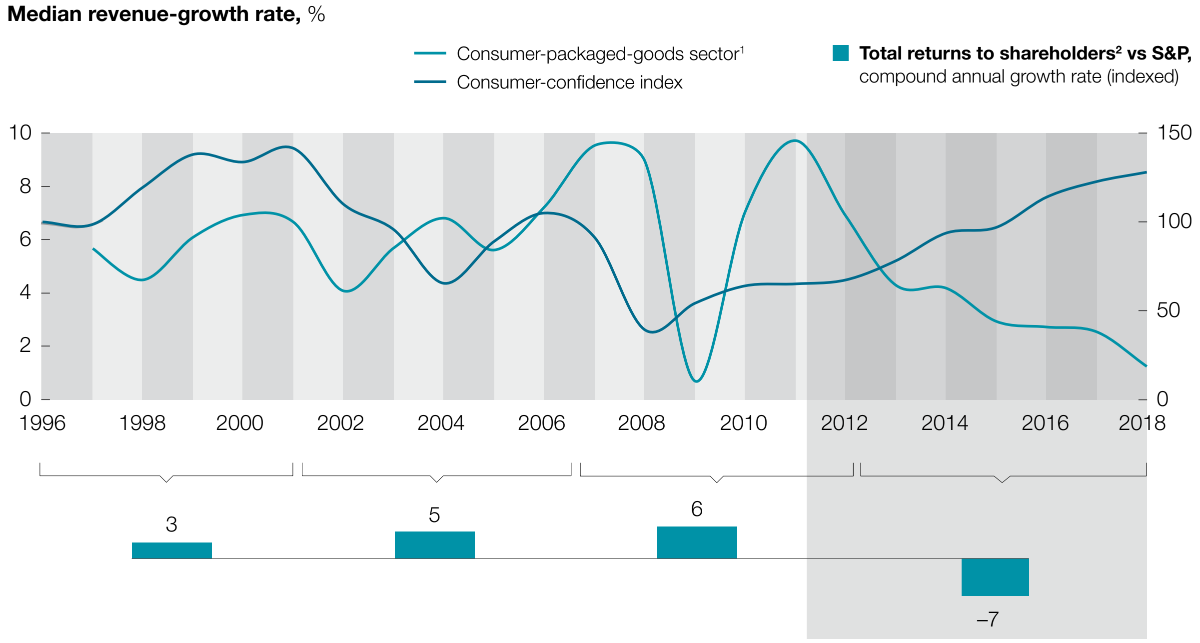
Total returns to shareholders (TRS) have underperformed the S&P since 2011. Growth has been a negative contributor to TRS, and margin expansion only a minor positive contributor.

The sector’s performance is attributable to changing conditions on several fronts. Consumers, channels, and competition are all different than they were a decade ago, stymieing CPG manufacturers that had become accustomed to the fairly stable growth brought about by rising consumer demand. And the next five years will almost certainly bring more change than did the previous five years. Many CPG executives recognize that they can’t continue to rely on historical growth models, but few have made sufficiently transformative moves—often, incremental change gets mistaken for transformation.

What will it take to jump-start and sustain profitable growth in the CPG sector? We believe CPG companies need a new model to drive their businesses—one that combines aspects of scale advantage, defined in new ways, with greater agility on multiple fronts. We call this model Agility@Scale (Exhibit 2).

Exhibit 1

Consumer-packaged-goods companies are facing an unprecedented growth challenge.



[1] Revenues based on local currency for US-oriented consumer-packaged-goods companies with revenues ≥$100 million (n = 195).

[2] Market-cap weighted index of US-oriented consumer-packaged-goods companies.

Source: Capital IQ by S&P Global; Datastream by Thomson Reuters; The Conference Board; Corporate Performance Analytics by McKinsey

The relative importance of each puzzle piece—and how they fit together—will vary by company. In this excerpt, we focus on the following elements of the model: agile reallocation, Consumer 3.0, and “thinking broad and small.”

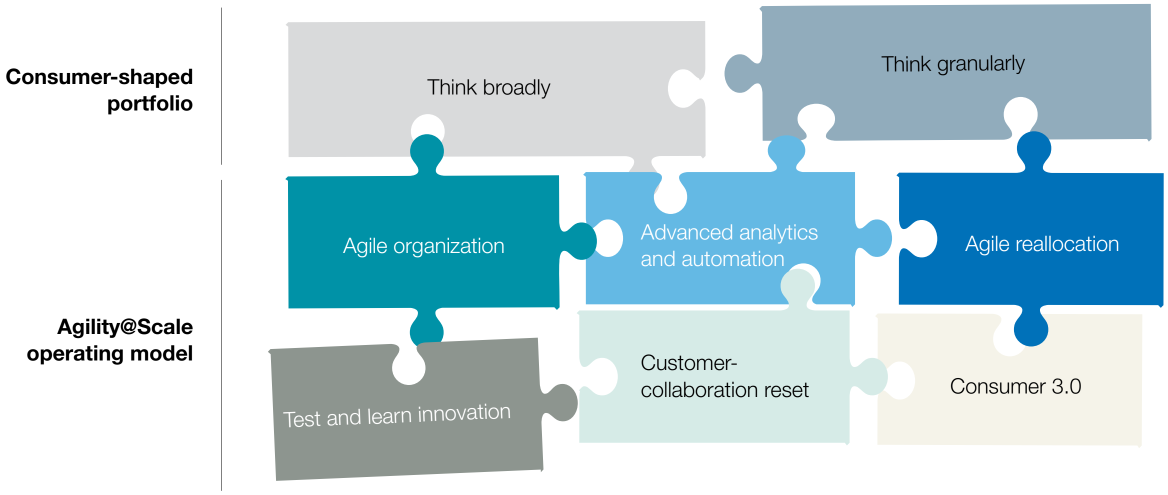
Fuel growth through agile resource reallocation

McKinsey research has shown that companies that are dynamic resource reallocators—meaning, they reallocate more than 49 percent of their capital over ten years—have achieved much greater TRS growth over time than their less dynamic peers. Unfortunately, most CPG companies are not very dynamic.

In particular, CPG companies must get better at shifting resources away from unpromising areas and toward areas of strength with the highest growth potential. Of course, this is easier said than done. Effective cost-reduction programs are part of the answer. And our research suggests that there is no significant trade-off between operating-expense efficiency and growth. Indeed, in recent years, some CPG companies have set a new bar in terms of cost efficiency without a growth penalty relative to their peers. So, framing cost reduction as a way to invest behind strength and coupling it with a fact-driven, enterprise-level strategic planning process that rethinks investment levels each year can be a way to capture TRS benefits.

Exhibit 2

There is an emerging model for consumer-packaged-goods sector growth.



Deliver next-generation consumer engagement: ‘Consumer 3.0’

In our experience, there is wide variability among CPG companies in how effectively they access and use the millions of “crumbs” of data available on consumers. In some data spaces, the CPG sector has fallen behind the retail sector and runs the risk of being at an information disadvantage in the value chain.

The best CPG companies are stitching together disparate data, sometimes in real time, to understand microsegments of consumers and to build more intimate profiles of consumer behaviors, attitudes, and needs. These companies are relying less on stated preferences and more on actual behavior. They are seeking to influence and engage consumers in a world where it is difficult to “own” the message fully with company-generated content. This “Consumer 3.0” approach stands in contrast to mass marketing (“Consumer 1.0”) and to digital marketing (“Consumer 2.0”), which relies upon company content and essentially replicates offline marketing in a more targeted and efficient way.

The potential scale advantage for large CPG companies lies in combining 3.0 approaches with more traditional 1.0 and 2.0 approaches. They should be complementary, not mutually exclusive. There is power in the ability to combine the brand awareness and presence associated with these high-reach (and high-cost) channels with the advanced-analytics– and data-fueled engagement of 3.0 approaches. CPG companies need a more expansive definition of “share of voice,” one that encompasses brand-owned content in traditional and digital channels, and the myriad other influence points for consumers. Larger players can potentially be more effective across this expanded share-of-voice landscape by using spend advantages in traditional channels along with advanced analytics and data capabilities in new channels.

Use Agility@Scale to go broader *and* smaller

One of the advantages of using the Agility@Scale model is the potential to compete across a broader range of market spaces. The basis for competition becomes a superior organizational and operating model—one that can translate into new arenas beyond near-in adjacencies. “Adjacency” thinking is, in some ways, a growth approach rooted in traditional notions of scale, such as capturing synergy because of manufacturing assets, distribution and customer advantages, and shared selling, general, and administrative functions.

CPG companies need to think more broadly about where to get growth and to follow the example of others who compete in new ways. Amazon is an example through its devices, cloud services, marketing services, entertainment-content development, and omnichannel grocery, among others. Some CPG companies are pushing the boundaries of their footprints, although not necessarily on the basis of Agility@Scale. Examples include Mars’s move into veterinary clinics, General Mills jumping into a high-growth space in pet food, and Nestlé moving further into the vitamins, minerals, and supplements space.

As for “thinking smaller,” the underlying concept is that growth is granular. This notion is nothing new: finding pockets of growth within larger category and geographic definitions has been a key to growth for a long while. What’s changing now is both the growing fragmentation of consumer preferences as well as the availability of data and technology to help companies understand the market landscape at a micro level. These changes raise the bar on a CPG company’s ability to use data and technology to market to growth pockets as well as its organizational agility to access them. In this way, the Agility@Scale operating model enables “thinking smaller,” just as it enables “thinking broader.” ■

Read the full article, “Agility@Scale: Solving the growth challenge in consumer packaged goods,” on McKinsey.com.

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‘Fast action’ in fast food: McDonald’s CFO on why the company is growing again

Kevin Ozan became CFO of McDonald’s in 2015. Since then, the restaurant chain has had a string of successes. Here’s his take on what’s working, what’s not, and what’s next for the iconic brand.

All photos © Doug McGoldrick

When Kevin Ozan assumed the CFO role in March 2015, McDonald’s was a company that seemed to have lost its way. Sales were in a prolonged slump, once-loyal customers were going elsewhere, competitors were eating away at its market share.

But quickly, the top-management team—led by new CEO Steve Easterbrook (whose first day as CEO was also Ozan’s first day as CFO)—developed a turnaround plan, which started showing results within months. By early 2017, the company was ready to replace its turnaround plan with a growth strategy.

Fast forward to 2018: Easterbrook, Ozan, and the rest of the current leadership team have revitalized the fast-food chain. They’ve turned around a massive operation—encompassing 37,000-plus locations in more than 100 countries, with annual revenues exceeding $20 billion—and set it on a path to strong, profitable growth. As of late 2018, McDonald’s same-store sales had risen for 13 consecutive quarters.

Ozan takes pride in the company’s solid financial performance, but he knows there’s a lot more work to do. The 21-year company veteran now oversees more than 2,000 employees, about half of whom are in McDonald’s finance departments (accounting, internal audit, treasury, tax, global business services, and investor relations). The other half work in either the technology function or in the company’s global restaurant operations and development group—two departments that began reporting to Ozan on January 1, 2019. A Midwesterner who says he eats McDonald’s food about three times a week (favorite menu item: the Egg McMuffin), Ozan is candid about the challenges that the chain continues to face—including recent declines in US customer traffic, operational hiccups in its restaurant remodels, and an intensely competitive talent market.

In November 2018, he spoke with McKinsey senior partner Greg Kelly at McDonald’s new headquarters in Chicago. He shared his thoughts on the company’s growth to date, how to sustain it, and his role in making it all happen.

McKinsey: *Not long after you became CFO, McDonald’s developed a three-part growth framework—retain, regain, and convert customers. Tell us about that. What’s worked best? Which of the three is the most difficult?*

Kevin Ozan: Our growth framework came out of research we conducted in our ten largest markets. It was the biggest consumer-research effort we’d ever done in our history. The research showed that what consumers want and why they come to McDonald’s—whether they’re in Germany or Japan or the United States—is much more similar than different. So our framework is universal; it allows us to speak a common language across the organization while still allowing local management to bring it to life for customers in their markets.

We’ve been really focused on the “regain” part. Before we launched the consumer research, we thought that the reason we were losing some customers was new trends—people moving away from quick-service restaurants (QSR) into fast-casual or more upscale dining. But the research told a different story: we were actually losing customers to our direct QSR competitors. On the one hand, that was frustrating because, obviously, we don’t want to lose to competitors—but on the other hand, we took a lot of satisfaction from it because we knew we could win those customers back. Those are people who like quick-service restaurants and who enjoy eating our food; we just weren’t giving them what they wanted. Thanks to the changes we’ve made in enhancing convenience, introducing new value platforms, and improving the customer experience, we’re regaining some of those customer visits.

“Retain” is about keeping the customers who have historically been our stronghold— families with young children and people who love McDonald’s breakfast.

Kevin Ozan

Vital statistics

Born in 1963, in Cleveland, Ohio

Education

Holds an MBA from the Kellogg School of Management at Northwestern University and a bachelor's degree in business administration from the University of Michigan

Career highlights

McDonald's

(2015–present)
CFO and executive vice president

(2008–15)
Senior vice president and corporate controller

(2007–08)
Vice president and assistant controller

(2006—07)
Senior director, investor relations

(2004—06)
Senior director, Chicago region finance

(2002—04)
Senior director, corporate controller group

(1997—2002)
Director of financial reporting

Ernst & Young

(1985—97)
Accountant

Fast facts

Chairman of the Ronald McDonald House Charities of Chicagoland & Northwest Indiana

Avid fan of the University of Michigan Wolverines football and basketball teams

Hobbies include hiking, reading thrillers and murder mysteries, and listening to pop, alternative, and new country music

"Convert" is about attracting new people to McDonald's by pursuing growth opportunities in places where we're not getting our fair share, so that's areas like coffee and snacks. It's probably the hardest of the three. We're making progress, especially with our McCafé proposition and our new specialty coffees.

McKinsey: *Let's talk about the "retain" part. You could have just left it out of the growth framework, but you didn't. How well has that worked?*

Kevin Ozan: One of the challenges for big organizations like ours is to do multiple things successfully at the same time. I liken it to a kids' soccer game: wherever the ball goes, that's where everybody runs to. In most of the world, our growth framework has helped us fight that instinct. We've continued to build on our strengths with families and the breakfast daypart. In the US, we had a bold agenda that required us to execute across many levers, and we didn't pay as much attention to breakfast as we should have. We didn't advertise and promote it as much, and we didn't introduce any new breakfast products for years. So, in the past couple of years, we've had negative traffic during breakfast hours in the US market. We've learned that we do indeed need to keep a focus on the "retain" part of our strategy. We can't take our strengths for granted. We're learning how to keep our eye on the things that are working well even as we go all in on new areas.

McKinsey: *Speaking of new areas, you've added some elements to the growth framework. You now have three "growth accelerators": delivery, digital, and the store remodels that you're calling Experience of the Future (EOTF). How do these accelerators relate to the retain-regain-convert framework?*

Kevin Ozan: Once we had our baseline growth framework, as a leadership team we asked ourselves, "Are we OK with where we are now, or do we have a greater growth ambition?" We knew we could do more, so we generated ideas that would help us achieve more growth. To prioritize the ideas, our primary screen was what would have the biggest impact on the most people in the shortest amount of time. That's how we came up with our three accelerators.

Delivery is one of them. Steve [Easterbrook] and I had visited a few countries where we could see that delivery was clearly a growth opportunity. We wanted to move faster than what would have been a typical approach for McDonald's, so we set up a "fast action" team—bringing together some of our best talent from different business units and different regions. We took them out of their day jobs and had them focus exclusively on getting into the delivery game and building momentum as quickly as possible. We launched McDelivery in three or four months, which, for McDonald's, was an incredibly short period of time; in the past, we would have tested it in one market, and then another, and maybe rolled it out years later. We partnered with Uber Eats in most of our markets because it had the broadest scale across multiple countries and was in the best position to help us launch, scale, and grow our delivery business the fastest.

McKinsey: *Uber Eats is taking the orders and making the deliveries, so Uber—not McDonald's—is getting the customer data, right?*

Kevin Ozan: It's true that data is a gold mine for learning more about our customers and giving them a more personalized experience. If I know that you like a Big Mac for lunch every Tuesday, for example, we can tailor our offer to your individual tastes. Right now, Uber does have the more detailed data on individual customers. We get summarized data such as time of day and location. We have a strong partnership with Uber and are exploring opportunities to share more information. We're also integrating delivery into our mobile app, which will help us gain insights that will allow us to develop one-on-one relationships with our customers. That's the goal.

We knew that McDelivery wasn't going to be perfect on day one. But it's proven to be a highly incremental business for us. It skews to a younger demographic, it generates a higher average check, we're seeing a high rate of repeat business, and most of the orders are placed in the evenings, when our restaurants have more capacity. Now that we've launched it, our focus is on optimizing that business. How do we grow

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We wanted to move faster than what would have been a typical approach for McDonald's, so we set up a 'fast action' team—bringing together some of our best talent from different business units and different regions.

awareness? How do we improve the packaging for items like fries and drinks? How do we make our operations more efficient? We're tackling all of those things now.

McKinsey: *Did you have the same philosophy in developing your mobile app? Get the app out there and then improve it as you go?*

Kevin Ozan: Yes. Some of our competitors already had an app, so we wanted to move quickly. If you think about your apps, you get updates constantly; consumers are used to that. An app doesn't have to have every bell and whistle on day one. Again, that wasn't an easy concept for our system given our historical strength in testing and "fail-proofing" initiatives before introducing them in our restaurants.

We're now working on improving the digital experience for customers. For example, if I order and pay through the app but I still have to line up at the drive-through and wait for my food, there's no payoff; I haven't really saved myself any time. So we've introduced curbside service: you order and pay through the app, then you park in a designated parking spot at the restaurant and the food is brought out to your car. Now there's a payoff of added convenience for the customer.

I see digital as a "greens fee" these days. You need digital offerings. But ultimately the winners are going to be the companies that can best integrate the physical and the digital, and make the overall customer experience as pleasurable as possible. That's what our third accelerator, Experience of the Future, is about—giving customers more choice in the way they order, pay, and receive their favorite food. EOTF has a number of components: one is modernizing and updating the physical restaurants—the décor, the seating—another is putting in digital self-order kiosks, and another is table service. So whether you're ordering from the kiosk or the front counter, you can just sit down, relax, and have the food brought to you. Table service is a great example of how we're trying to increase the level of hospitality that customers experience in our restaurants.

McKinsey: *EOTF is a lot more capital intensive than the other two accelerators. How did you decide it was worth the investment?*

Kevin Ozan: One advantage of having a large system like ours is that once we started implementing EOTF internationally—in places like Australia and Canada—we consistently saw that it resulted in sales lifts of roughly 4 to 6 percent, so we knew we were getting good returns on our investments. We're spending more than $1 billion this year on remodeling US restaurants. We're trying to do it at a quick pace—about 1,000 restaurants per quarter—because McDonald's customers expect consistency. If you go to one restaurant that's remodeled, and then the next day you go to a restaurant down the street that isn't, that's a confusing and disappointing customer experience.

Greg Kelly and Kevin Ozan at McDonald's corporate headquarters in Chicago. Behind them is a display of Happy Meal toys from years past.

What we're seeing in the US is that our remodels are taking a little longer, partly because the restaurants are older and need more work. It's also taking longer for customers to come back after a remodeled restaurant reopens. The good news is that once they do come back, we're seeing sales lifts similar to what we saw in international markets.

McKinsey: *It sounds like you personally are spending a lot of time on the various elements of the growth strategy, rather than on purely financial matters. Is that just inevitable when you're the CFO of such a growth-oriented company?*

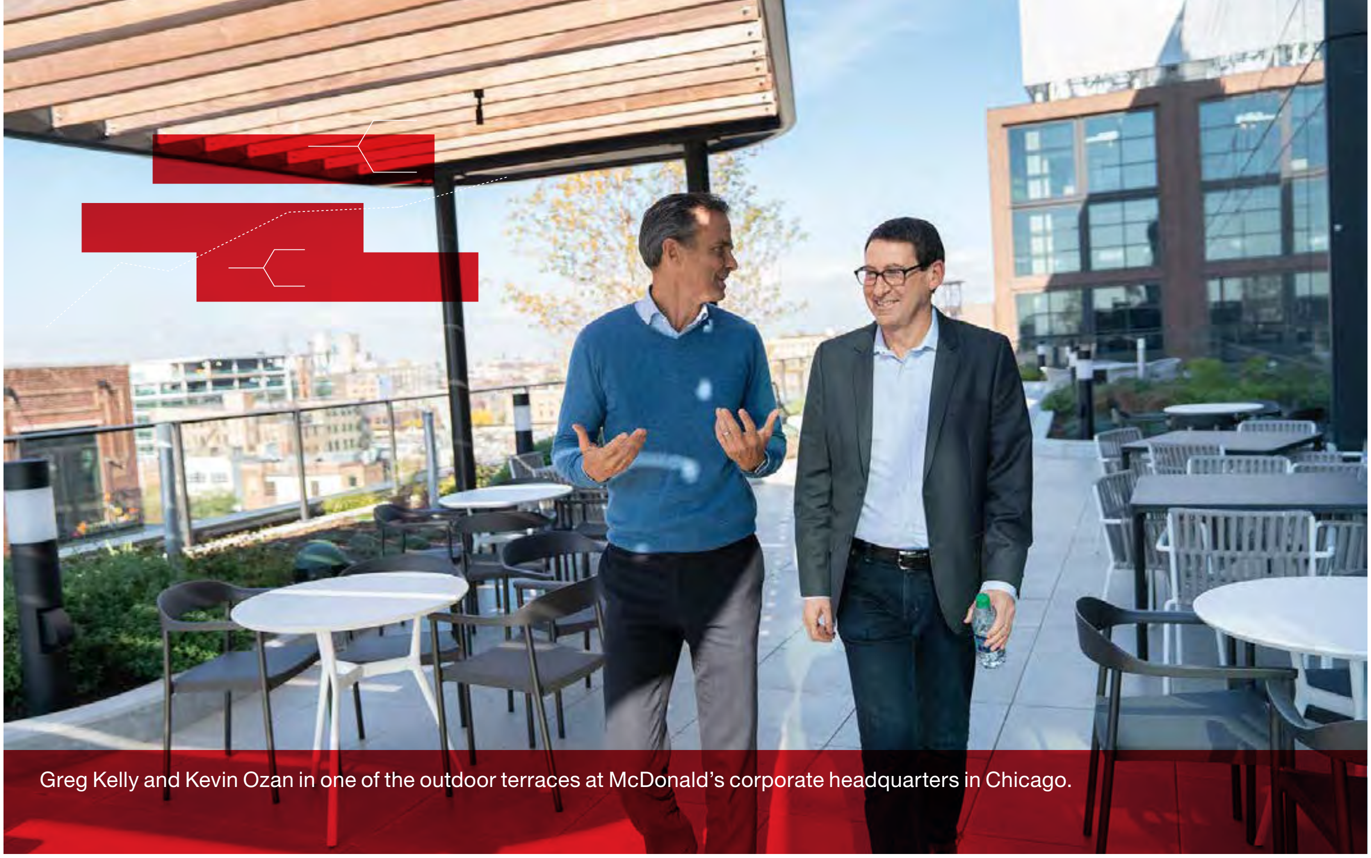
Kevin Ozan: As a CFO, one of the biggest challenges is determining where you spend your time. Everybody wants some of your time, whether that's the board, the CEO, employees, franchisees, or suppliers. You've got to spend your time where you can have the biggest impact. When I became CFO, we were in turnaround mode, so my time was spent determining the right cost structure, the right capital structure, how and where to franchise more—in other words, deep financial analyses.

As we've transitioned into growth, I'm now spending more of my time on strategy, innovation, IT, and digital initiatives. I enjoy that. Finance people, just like everyone else, want to use their creative side; we want to be strategic business partners rather than work purely on financial issues.

McKinsey: *What's an example of a time when either you or your finance colleagues were creative and helped enable the growth strategy?*

Kevin Ozan: Delivery is a great example because it was a new business model for us. We understood the profitability of a front-counter and a drive-through sale, but with delivery, all of a sudden, the customer has to pay a delivery fee, and there's a commission to the delivery provider. It's a whole new way of thinking. We've had to educate ourselves and our franchisees that the percentage of profitability may not be as high as a front-counter sale, but as long as that business is sufficiently incremental, it will earn incremental dollars.

So our finance staff has been figuring out the right financial model for delivery. Are there different models we can work with our providers on? What's the sensitivity of customers to the delivery fee? Does it matter if we change the split between the commission and the delivery fee? And so on.



Greg Kelly and Kevin Ozan in one of the outdoor terraces at McDonald's corporate headquarters in Chicago.

McKinsey: *You lead a very large finance organization. What leadership traits do you look for in your staff? What traits do you feel have been important in your own success?*

Kevin Ozan: I think CFOs and finance people need exceptional communication skills. That may not be the first thing that you'd associate with finance people, but in my role, I always have to adapt my communication style and messages to different constituencies—whether it's the board of directors, our leadership team, employees, or franchisees.

Finance leaders need to be able to explain financial concepts to nonfinancial people. You have to be able to bring complex ideas down to a level so that everyone is nodding their head and saying, "I understand what you're talking about." That's how you get things done in a large organization.

As a finance team, one of our most important roles is to produce facts and data, analyze the data, provide insights to tell a story about what's happening and why, and then propose solutions and influence decisions to help grow the business. I need to ensure that members of my finance team are focused on that, because it's not exactly the way you learn in business school.

McKinsey: *How do you think you became good at communication? Did you have to learn it? Or do you think it was innate?*

Kevin Ozan: I learned writing skills in my first job out of college. I had a mentor who was a strong writer, and she taught me how to convey my ideas in a logical, thoughtful manner so that people can easily understand what I'm saying, whether I'm writing just a short email or a long memo. Developing those writing skills also helped me become a better speaker.

Also, my career at McDonald's has exposed me to many different perspectives. That has helped me communicate better with a wide range of people. I started out in financial reporting, where I gained a good global perspective of the business from the corporate side. I then had the opportunity to work in Sweden, which gave me an international perspective. I spent some time out in the field working with franchisees, which was another new perspective, because franchisees view the business very differently from the way we did at headquarters. I came back and went into investor relations, which gave me an investor and analyst perspective. Gaining all these different perspectives has been incredibly valuable in my current job.

McKinsey: *Do you spend a lot of your time on people issues?*

Kevin Ozan: Absolutely, and it's something I really enjoy. I spend more time on recruiting, talent development, and employee engagement than one might expect. Top talent is scarce and provides a competitive advantage. Right now we're in a war for talent; many of the people we're trying to hire have several job offers on the table. That's true not just at the corporate office but also in our restaurants. With unemployment low in many countries, I expect that talent and labor issues will continue to be a challenge.

We're investing a lot in upskilling our employees. Our Archways to Opportunity program, for example, helps our non-English-speaking restaurant employees learn English and provides tuition assistance so that employees can get high-school and college diplomas. We've recently launched a program providing free career-advising services and tools. We're investing $150 million over five years in building the capabilities of our restaurant employees, so that they can have great careers whether they choose to stay at McDonald's long term or not.

McKinsey: *Last question: What's next for McDonald's? What are some things you're working on that could take the business to the next level?*

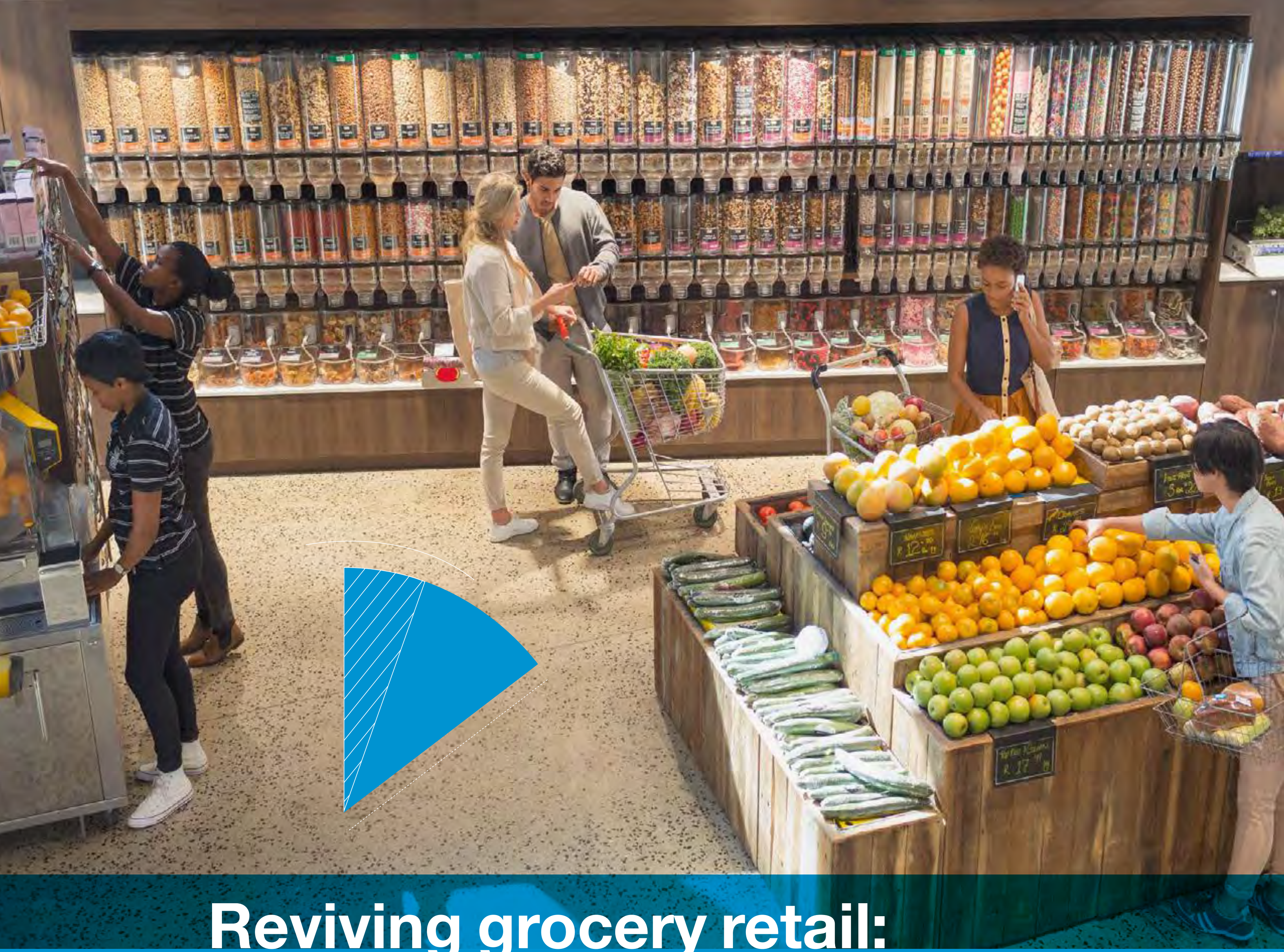
Kevin Ozan: We're constantly reinvesting in our existing restaurants, of course, because nothing is as profitable as growing like-for-like sales. But we also think there's room for new restaurants, even in our mature markets, like the US, Canada, and France.

That said, the biggest area of increase in our spending has been in technology, which is helping to drive our growth. I expect that will continue. We're looking at how to use technology to improve the customer experience and create new customer experiences. We're also exploring technologies that can help us reduce or eliminate repetitive tasks and make employees' jobs more interesting and rewarding. In our finance organization, we're piloting robotic process automation and other technologies. In our restaurants, we have a team looking at automation opportunities that can help drive labor efficiencies.

I'm a big proponent of intellectual curiosity and agility—learning new areas and keeping up with what's going on with the world, whether that's analytics or blockchain or something else—and getting things done quickly. At McDonald's, we're more curious than ever, and we're getting better at agility. That means our customers, employees, and franchisees will have lots of new things to look forward to. ■

To hear audio clips from this interview, visit McKinsey.com.

Kevin Ozan is the CFO of McDonald's Corporation, based in Chicago. This interview was conducted by **Greg Kelly**, a senior partner in McKinsey's Atlanta office.



Reviving grocery retail:
Six imperatives

In the United States and Western Europe, many traditional grocery retailers are seeing their sales and margins fall—and things could get even worse. Here's how to reverse the trend.

Dymfke Kuijpers, Virginia Simmons, and Jasper van Wamelen

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To put it bluntly, much of the $5.7 trillion global grocery industry is in trouble. Although it has grown at about 4.5 percent annually over the past decade, that growth has been highly uneven—and has masked deeper problems. For grocers in developed markets, both growth and profitability have been on a downward trajectory due to higher costs, falling productivity, and race-to-the-bottom pricing. One result: a massive decline in publicly listed grocers' economic value.

And it could get much worse. Monumental forces are disrupting the industry. If grocers don't act, they'll be letting $200 billion to $700 billion in revenues shift to discount, online, and nongrocery channels[1] and putting at risk more than $1 trillion in earnings before interest and taxes (EBIT).[2] When the dust clears, half of traditional grocery retailers may not be around.

What has driven the grocery industry to this point? The disruption can be attributed to three major forces: consumers' changing habits and preferences, intensifying competition, and new technologies. Each of these forces is, to some extent, always at work, but the speed and magnitude of change have caught most grocers off guard.

These disruptions present considerable—yet surmountable—challenges. Based on our research into the global grocery industry, combined with our extensive experience working with the world's leading grocers, we have identified six imperatives for grocers to win in this rapidly changing environment.

Disruption on three fronts

In the past decade, sales growth among large grocery chains in the mature markets of North America and Western Europe has been a pallid 2 percent (compared with 9.8 percent in Africa, 8.4 percent in Eastern Europe and South America, and 6.2 percent in Asia). Even that 2 percent growth has been hard won. Between 2012 and 2017, as commodity prices and labor costs increased, traditional grocers in developed markets couldn't charge higher retail prices because competition from lower-priced formats—such as discount chains and dollar stores—was just too intense. Grocers' margins fell dramatically, forcing grocers to sweat their assets. During that period, more than 50 percent of the economic profit of large publicly traded grocery retailers evaporated (Exhibit 1).

This kind of upheaval has made the industry ripe for a major shakeout. Already, consolidation is on the rise, especially within countries. M&A activity in Europe and North America is picking up again after a dip in 2016, with the recent announcement of the proposed Sainsbury's–Asda merger exemplifying the trend. We believe consolidation will continue apace—and could eventually spell the demise of all but the two to four strongest grocery retailers in each market. These grocers will have to battle it out with the likes of Walmart, Costco, discounters, and the new "ecosystems" of Alibaba and Amazon. Grocery chains' contribution to GDP could decline by $90 billion or even twice that, depending on the level of automation (which would reduce retail prices and labor costs) and the size of the shift toward e-commerce.

It's a grim picture. Of course, consumer behavior is never static, technology is constantly advancing, and new competitors are always emerging in one form or another—but the pace and intensity of all three of these forces have been unparalleled. Very few grocers have managed to turn these forces to their advantage.

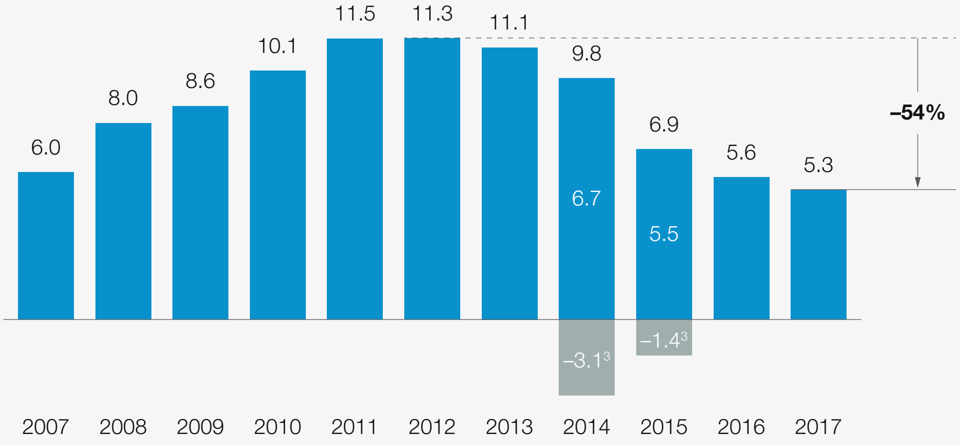
Changing consumer habits and preferences

Consumers today expect to be able to buy almost anything, anywhere, at any time—and at low prices to boot. Millennials, which now constitute the largest US demographic group, have especially high expectations. In a UK survey of grocery shoppers, millennials said they seek healthier food choices. They also want to know exactly where their food comes from and how

Exhibit 1

More than 50 percent of the grocery sector's economic profit vanished between 2012 and 2017.

Economic value add[1] of publicly traded grocery retailers,[2] $ billion



[1] (ROIC – WACC) * IC: return on invested capital minus weighted average cost of capital, multiplied by invested capital.
[2] Analysis of 27 largest publicly traded grocery retailers worldwide.
[3] Losses from Tesco accounting issues.

Source: McKinsey Corporate Performance Analysis Tool

it's made; they expect companies to be socially and environmentally responsible and to offer sustainable, traceable products. At the same time, they want deals and discounts—not surprising, in light of the fact that they are the first generation that is less wealthy than their parents. Finally, millennials are drawn to the seamlessness and convenience of online shopping. Grocers therefore find themselves in the difficult position of trying to meet all these expectations without raising prices.

Baby boomers, too, have considerable buying power and thus are an important customer base for grocers, but present additional challenges. For one, baby boomers are different from past elder generations. They're retiring later in life; many more of them are single; many more are comfortable with technology. They're more concerned about health and wellness, they value in-store customer service, and they're more open to new products and experiences, especially those that are unique to their life stage.

Grocers have to adapt their offering accordingly while, again, keeping prices low.

One behavioral change common to every demographic group, including millennials and boomers, has posed an enormous challenge for the grocery industry: people are less inclined to cook. Almost half of US millennials say they rarely prepare meals at home. Across the board, more consumers are buying ready-made meals. In both Europe and the United States, food service is growing faster than food-at-home consumption; in the US market, food-service revenues already exceed food-at-home sales.

Aggressive competitors and the emergence of ecosystems

Grocers were slow to adapt to these changes in the consumer landscape, so other types of retailers quickly stepped in. Discounters, convenience-store chains, club stores, dollar stores, and pure-play online retailers got into the grocery game. Consumer-packaged-goods (CPG) manufacturers began selling directly to consumers. Food-service players captured the lunch and dinner occasions.

Discounters, in particular, came on strong. Schwarz Group, which owns discounters Lidl and Kaufland, is now Europe's largest food retailer. Discounters have a market share of 20 to 50 percent in Germany, Ireland, and the Netherlands; ALDI and Lidl are beginning to flex their muscle in the US market as well. With a limited assortment and a focus on delivering great value for each item, discounters maintain higher earnings before interest, taxes, depreciation, and amortization than supermarkets, but their low prices have reduced the sector's overall revenue by about 4 percent.

Low prices are also part of the consumer appeal of online players like Amazon, which is just getting started in grocery: its acquisition of Whole Foods

© Maskot/Getty Images

Market is a game changer. The combination of Amazon's digital and operational prowess, Whole Foods Market's brick-and-mortar stores, and the two companies' customer base creates an omnichannel behemoth—a retail ecosystem that grocers have to reckon with.

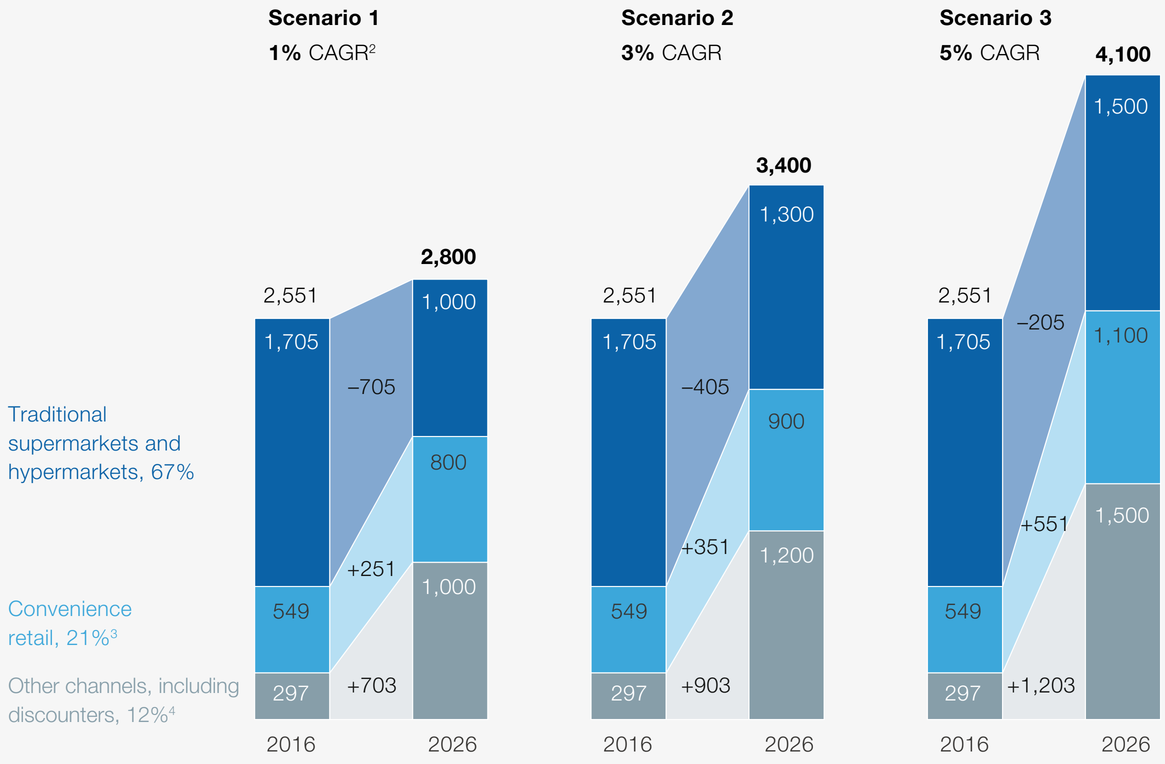
Indeed, ecosystems are emerging around the world and generating much of the growth in e-commerce. In China, Alibaba aims to seamlessly integrate online and offline channels; it calls its ecosystem "New Retail." Data-driven personalization, as well as network and scale effects, drive down ecosystems' costs while locking in customers.

Our analysis suggests that, by 2026, between $200 billion and $700 billion in revenues from traditional grocery retailers could shift to other formats and channels—further hurting sales productivity and aggravating space overcapacity (Exhibit 2).

Exhibit 2

By 2026, up to $700 billion could shift from traditional grocery to other formats and channels.

Scenarios for grocery retail sales 2026,[1] North America and Western Europe, $ billion



[1] Channel split in 2026 of total grocery retail sales is modeled as 25–50% traditional grocery, 25–30% convenience, and 25–45% other channels.

[2] Compound annual growth rate.

[3] Assuming 1–2% CAGR in line with food-service trends.

[4] Other channels include discounters, online, club, and direct-to-consumer sales. Estimated growth rates are based on market-share outlook by channel (eg, discounters' continued growth in Western Europe, 13% CAGR in United States based on recent entry of Lidl; online CAGR of 10% assuming online maturity in United Kingdom will hold for most US and Western European countries 10 years from now).

Source: Euromonitor; Verdict; McKinsey analysis

New technologies

A related (and equally disruptive) trend is the onslaught of new technologies. The success of Amazon and other online competitors is due in part to the price transparency that the digital world has enabled. To remain competitive, offline retailers have had to keep prices low even when their costs have risen.

Furthermore, most grocers haven't deployed cutting-edge technologies—including digital solutions, advanced analytics, artificial intelligence, robotics, and the Internet of Things (IoT)—as quickly and aggressively as their competitors have. For instance, Amazon's website features a robust product-recommendation engine powered by advanced analytics, the company has more than 100,000 robots transporting bins and stacking pallets in its warehouses, and it has introduced innovations to make shopping faster and easier, such as its Echo and Dash devices. Many traditional grocers find themselves constantly having to play catch-up.

Six imperatives for profitable growth

But all is not lost. Resourceful and nimble grocers have shown that it's possible not just to fend off competitors and hold on to market share but also to attract new customers and keep them coming back. Profitable growth is achievable—but it will take decisive action in each of the following six areas.

1. Define a distinctive value proposition: Convenience, inspiration, value for money

To hold their own against aggressive competitors, grocers must build a distinctive offer that emphasizes one or more of the three value propositions that have resonated with today's consumers:

- *Ultraconvenience.* Convenience is partly about having store locations that are easy to get to, such as at train stations or in residential neighborhoods. But location is only one aspect of convenience. Retailers should strive to make every part of the shopping experience more convenient, while maintaining standards of quality far above typical convenience-store fare. A grocery store's assortment might include grab-and-go items, prepared foods, frozen meals, and loose fruits and vegetables for shoppers looking for a quick snack. It might also provide self-service options, express checkouts, home delivery, and other in-store services, such as dry cleaning or package pickup.

- *Inspiration.* A grocer can differentiate itself by creating an inspiring and exciting shopping experience that helps customers discover new products. Some grocery stores now feature digital signage that offers extensive product information, including products' origins and nutritional properties. Others try to create an environment that feels like walking through a cookbook, with fully prepared meals on display or cooked on the spot, along with recipes and ingredients in the correct portions. A grocer might decide to offer a variety of health-and-wellness options, with an unrivaled assortment of specialty, organic, and local brands. A mix of education and entertainment—for instance, cooking classes taught by a celebrity chef—can also transform the shopping experience.

- *Value for money.* This is, obviously, the value proposition of mass retailers and discounters, which means competing on this front will be highly challenging for traditional grocers. To stand a chance, a grocer would need considerable scale and a low-cost operating model. Practically, this would require expertly leveraging big data and analytics, partnering with other retailers on sourcing, and dramatically "leaning out" stores, whether through automation or by adopting a discount-store model. A more likely path for a traditional grocer might be to ensure that it's almost on par with competitors in value for money, but focus on either ultraconvenience or inspiration as a differentiator.

2. Shape your ecosystem—and either go big or get out

To stay competitive against the aforementioned emerging ecosystems, retailers must make big bets on which battlegrounds to fight in and, subsequently, which digital and analytics "use cases" to master. This requires a forward-looking perspective on how consumer behavior, the competitive landscape, and technology are likely to change in five years or more. What are the potential disruptions? What will the growth areas and profit pools be? Important choices will revolve around food and nonfood assortments, payment systems, customer interfaces, service options, and last-mile delivery.

And going it alone won't work. To create an ecosystem, retailers must fill any capability gaps through partnerships or M&A—for example, by joining forces with digital, analytics, technology, or convenience specialists. The goal is to start a virtuous cycle of using data and analytics to get closer to the customer, then gathering more data with every customer interaction—and radically reducing the total costs of the system by bringing together people, commodities, and venues.

Let's look at last-mile delivery as an example. In online grocery, delivery costs are the biggest hurdle to profitability (Exhibit 3). It's a hurdle that can be overcome only with major investments in advanced analytics, warehouse relocation, and automation. If a grocer isn't willing to go big in e-commerce, it might as well get out.

Low "drop density" is the main reason for high delivery costs: a typical delivery-van driver in the United Kingdom, for instance, makes fewer than five deliveries per hour on average. Potential solutions for increasing drop density include a milkman model, whereby retailers make deliveries to communities only at specified times each week. A small Dutch grocer, Picnic, has achieved a drop density of 14 deliveries per hour with this model.

Another potential solution is pooled deliveries, which would require grocers to collaborate with their competitors or with other businesses: for example, one player or a third-party logistics provider could combine several retailers' deliveries. In China, about 50 companies have been piloting an app that mobilizes an on-demand pool of thousands of independent drivers to deliver goods. The app contains profiles and user ratings of drivers, and it indicates whether they're available and willing to help unpack items. To aid drivers as they navigate neighborhoods, the app offers detailed trip planners and route maps.[3] Early trials have indicated that this approach could shave 30 percent off retailers' delivery costs.

Another way to make deliveries cheaper is to store the goods closer to where people live. According to our analysis, if a large retailer relocates half of its distribution centers closer to city centers—from, say, 100 kilometers away to only 10 kilometers away—it could reduce delivery costs by about 10 percent.

Using drones or fully automated vehicles for a fraction of deliveries could also reduce costs. But again, these solutions aren't cheap. Grocers must decide to take the plunge into omnichannel retail, or stay out altogether.

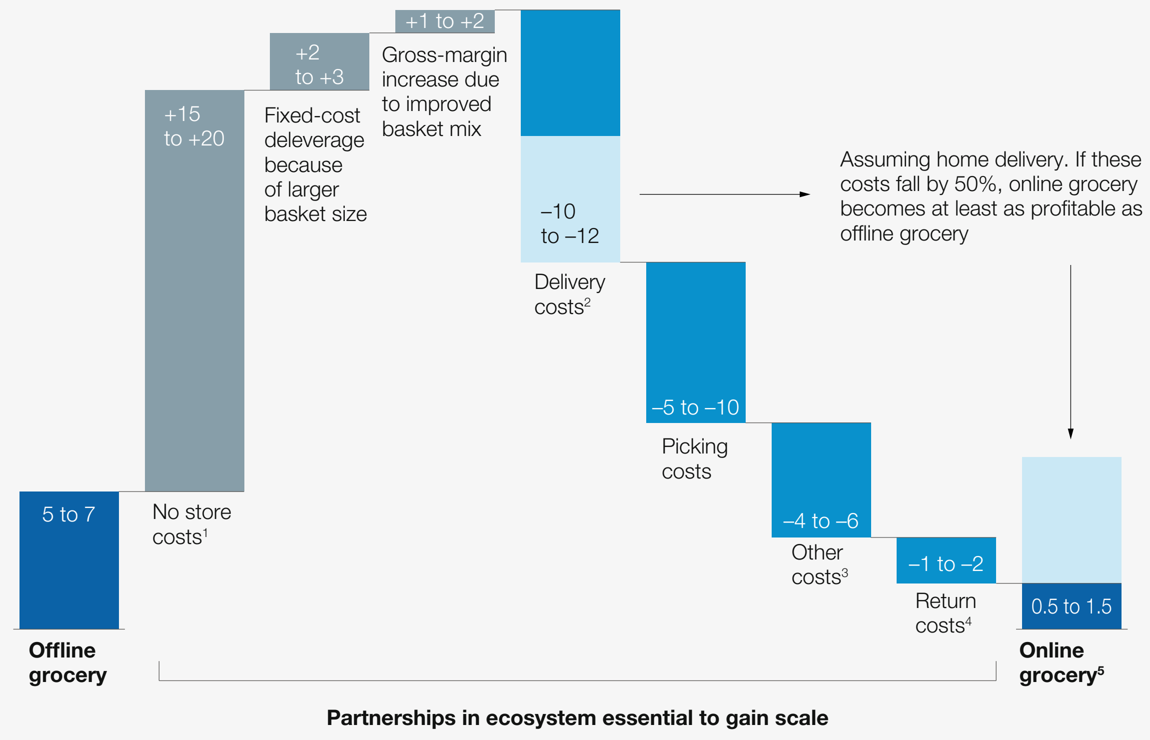
3. Put technology to work in every part of the value chain

The most successful grocers have embraced technology as the primary driver of commercial effectiveness and cost reduction across the value chain. Indeed, their use of technology is what sets grocery leaders apart from laggards; early adopters are capturing 2 to 5 percent more in EBIT than slower-moving competitors. Digital solutions, advanced analytics, and artificial intelligence can have far-reaching impact on customer engagement, commercial activities, store and warehouse processes, and back-office operations.

Exhibit 3

Online grocery would become more profitable if retailers could reduce delivery costs.

Profitability per basket, % of sales



[1] Such as rent or in-store labor.

[2] Typically, the retailer's delivery fee is lower than the actual delivery costs.

[3] IT, credit-card fees, marketing.

[4] Return costs are usually due to substitution: when an item is not available and the retailer sends a substitute, the customer sometimes returns the substitute.

[5] Not accounting for cannibalization of offline sales.

Customer engagement

In a recent survey of retail CEOs, 93 percent said they see personalized marketing as a priority. Personalization—not just of marketing messages and offers but also of product recommendations and content—can yield up to 2 percent top-line impact. But many traditional grocers have trouble optimizing their mass promotions. Only a few grocers, such as Kroger and Loblaws, already personalize their promotions to loyal customers. More-advanced retailers are working toward "here and now" personalization efforts, which deliver the right offer at the right price, right time, and right location.

Commercial effectiveness

Advanced analytics can enable grocers to make better decisions about assortment, pricing, and promotions. Already, sophisticated retailers are creating hyperlocalized assortments while maintaining a centralized merchandising function. They're identifying which items play a unique role in the assortment and conducting space-sensitivity analysis to determine the best store-specific planogram. They're defining price zones using micromarket segmentation and comparing prices automatically with key national competitors. They're monitoring, evaluating, and tweaking their promotions daily. And they're generating insights that give them negotiating leverage over their suppliers.

In-store and warehouse operations

Up to half of in-store tasks could potentially be automated. Robots can now answer shoppers' questions, suggest items based on a shopper's previous purchases, take inventory, keep track of expiration dates, stock shelves, pick and pack products for delivery, clean up spills, and even assemble sandwiches and salads. The partnership between Kroger and Ocado, a leader in warehouse automation and end-to-end use of advanced analytics, suggests greater opportunities to offer same-day and same-hour delivery from "dark stores" with little or no staff. Retailers are testing no-checkout models: examples include Amazon Go, Ahold Delhaize's "tap to go," and China's BingoBox, a chain of unstaffed convenience stores. Since manning checkout registers represents about 30 percent of store labor—and slow checkout is among the top pain points for grocery shoppers—the benefits of redeploying that 30 percent to higher-complexity tasks would be massive.

Back-office operations

Our experience in other sectors, particularly in financial services, has shown that digitization of back-office processes (such as accounts-payable handling or payroll processing) can yield significant productivity improvements. We often find that a majority of back-office processes could potentially benefit from digitization, which can free up 15 percent or more of employees' time overall—an enormous opportunity for grocers.

4. Win back lunch and dinner

Grocery stores were once the place where almost everyone bought their lunch and dinner. In efforts to reclaim that role, many grocers have expanded their selection of ready-made meals and prepared foods. Some are bringing master chefs into the store.

There are several different models for food-service execution, including having a full-service restaurant next to the supermarket, dedicating a section of the store to ready-made meals or in-store dining, operating a "food hall" that has restaurants as well as retail shelves, and introducing store-in-store concepts that focus on niche foods (such as the Sushi Daily counters inside select Waitrose stores). In addition, many grocers—recognizing the growing consumer demand for healthy meals at home—are finding ways to meet that demand. In China, for instance, food retailers such as Hema and 7Fresh are offering home delivery within 30 minutes.

To succeed in food service, grocers must think through their approach by agreeing on answers to the following questions:

- Which archetype will we pursue (food for now, food for later, or both)?
- What store space will we use?
- Who will operate the food-service offering—in-house staff or a third party?
- What brand will it carry (a store brand, an existing food-service brand, or an entirely new brand)?
- Should we offer fast delivery? If so, what's our plan for making last-mile delivery work?

> Some store space could conceivably be reallocated to fulfilling online orders or providing other services.

Of course, each grocer’s answers to these questions will depend on a number of variables, including its particular strengths and weaknesses, the customer segments it serves, and the local competitive landscape. In some inner cities, popular food-service players have a higher density of outlets than the leading grocers.

5. Rethink all of your real estate

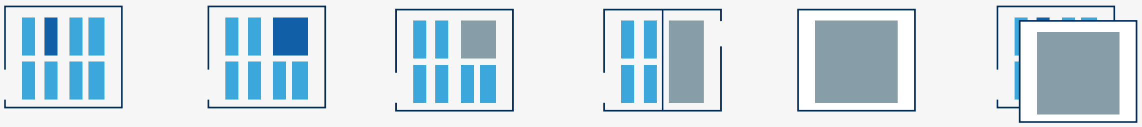
Grocers must get creative with their real estate. Closing stores is certainly an option, but it shouldn’t be the first or only one that they consider. For starters, grocers must think ahead to the future needs of their online businesses; some store space could conceivably be reallocated to fulfilling online orders or providing other services.

Retailers can address overcapacity in their portfolio in several ways (Exhibit 4). Options include reinvigorating core categories within a store, repurposing certain areas of the store, renting out space to other businesses, right-sizing the store,

Exhibit 4

Grocers can address overcapacity in a number of ways.

Potential levers for addressing real-estate challenges



Reinvigorate	Repurpose	Rent out	Right-size	Remove	Reinvent
Invest space in core or “battleground” categories to drive foot traffic and to differentiate from discounters	Add new categories and services (eg, cafe, sushi bar)	Bring in tenants and create shops-in-a-shop for “halo” benefits	Shrink the store’s footprint and sell or rent a portion to another business	Close the store; sell building or end lease while maximizing profit	Unlock property value by redeveloping the site as a mixed-use site (eg, with residential)

removing it from the network entirely, or redeveloping it as a mixed-use property, perhaps with residential space—an especially palatable solution in regions with housing shortages.

The most forward-thinking retailers, recognizing their need to raise capital and reduce liabilities, are collaborating with property developers and land owners—entities that have the requisite balance sheet, capabilities, and relationships with local authorities. In partnership with these entities, they can come up with options for the entire store portfolio instead of evaluating each store independently.

6. Innovate ten times faster

Speed is critical, which means grocers must jettison their traditional—and slow—approach to implementing new initiatives. They should instead take an agile approach using "concept sprints." Characterized by quick decision making, a focus on tangible outcomes, constant customer validation, co-located and multidisciplinary teams, rapid iteration, and careful attention to internal capability building, concept sprints can reduce time-to-market from four to six months to just four weeks.

Exhibit 5 shows how concept sprints can be used across the organization to accelerate the launch of

Exhibit 5 **Concept sprints can be used across the organization to speed development of priority initiatives.**

Inception	Day 2	Day 4	Day 8	Day 10	Day 13	Day 16	Day 20	After approval
Initial concept direction (business objective)	Conducted 50 user interviews to assess shopping journey	Created customer segments and journeys, selected target customer	Developed and designed digitally enabled shopping concept	Conducted 20+ user tests on target customers to refine concept	Designed technical solution and high-level IT architecture	Created and validated business case and investment road map	Refined and implemented road map, developed investment proposal	Technical proof of concept in lab environment

Using this approach, team developed proof of concept ~5x faster (4 weeks vs typical 4-6 months)

high-priority initiatives. Leading retailers have used such an approach to introduce new in-store digital solutions, refine picking algorithms in warehouses, or develop new products.

■ ■ ■

For traditional grocery retailers, a return to profitable growth won't happen without tough decisions and bold moves. The competitors that are already eating grocers' lunch (and dinner, too) are moving quickly, and they're harnessing the power of technology to improve operations and relentlessly pull customers away from traditional grocery stores. It's up to grocers to fight back—and perhaps join forces with one another (within the bounds of anticompetition and antitrust laws, of course)—to regain scale and effectively compete in the fast-changing and hotly contested food retail market. ■

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[1] Scenario-analysis estimates based on 2011 to 2016 observed market and market-share growth rates.

[2] Estimate considering additional labor costs required to meet rising consumer expectations for in-store service, assuming costs cannot be passed on to consumers.

[3] Lambert Bu, Yuanpeng Li, and Min Shao, "An 'Uber' for Chinese e-commerce," *McKinsey Quarterly,* January 2017, McKinsey.com.

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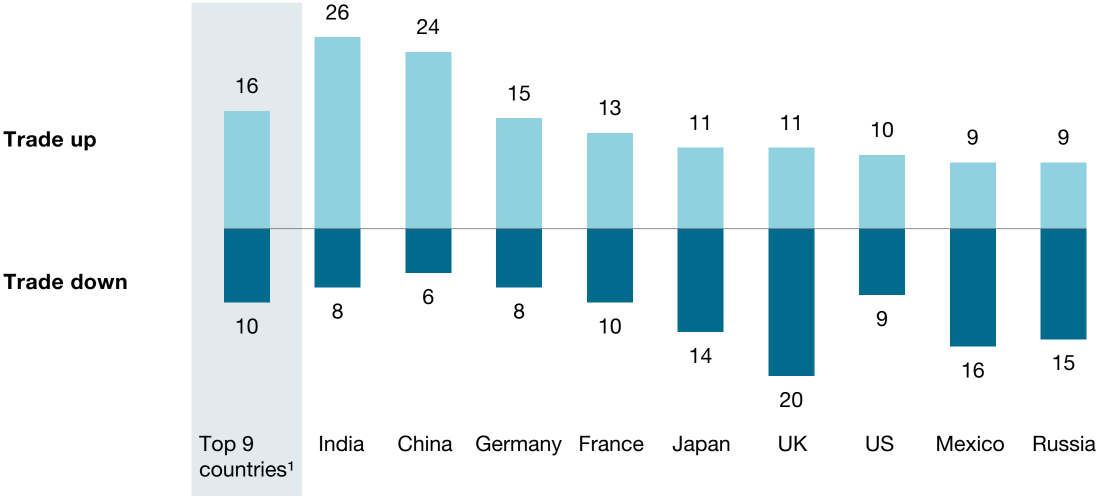
Global consumer sentiment: Still on an upward trend

Max Magni, Anne Martinez, and Alex Rodriguez

According to the latest McKinsey survey on global consumer sentiment, conducted in September 2018 across 15 countries, consumers in almost every part of the world are feeling better about their finances than they did the previous year. (This upward trend has been evident since our first global survey in 2015 but is decelerating.) The survey reveals that more consumers are choosing higher-priced brands, too. In particular, the percentage of survey respondents in India, China, and Germany who said they're trading up—that is, buying more-expensive brands of consumer packaged goods—significantly exceeds the percentage who reported trading down (exhibit).

Consumer trade-up rates were highest in India, China, and Germany.

Changes in buying behavior in past year (among those who changed their buying behavior), %



[1] Based on total household consumption of the consuming class (defined as the population with a household income of at least $10 a day).

Source: McKinsey Global Consumer Sentiment Survey, September 2018

Our survey also explored changes in consumers' eating habits and preferences. It confirmed a continuing trend toward healthier food choices, especially among millennials. For example, half of millennial respondents (and 41 percent of Gen X respondents) said that "all natural ingredients" is usually or always an important consideration for them when shopping for packaged foods.

For more highlights from the global survey, as well as country-specific findings, see our forthcoming articles on McKinsey.com.

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Commercial excellence in China

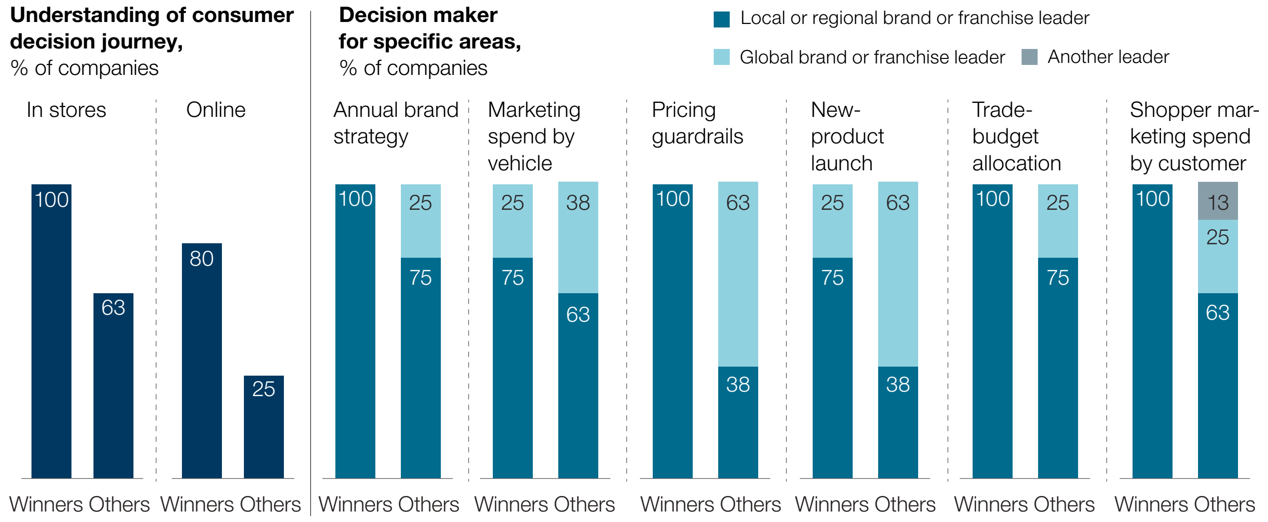
Daniel Hui, Felix Poh, Alex Sawaya, and Simon Wintels

What does it take to succeed in the fast-changing, wildly competitive Chinese consumer-packaged-goods (CPG) market? Our latest Commercial Excellence Benchmarking yields some answers. A collaborative effort between McKinsey and Nielsen, our global benchmark reveals what "winners" do differently from "others"—winners being companies that achieved higher sales growth than the categories they play in, while also outperforming peers on one or more commercial metrics.

We found, for instance, that winners in the Chinese market invest in generating both offline and online consumer insights. As the exhibit shows, all winners say they understand the in-store consumer decision journey, and about 80 percent of winners (but only 25 percent of others) say they understand the online consumer decision journey as well—making them much better positioned to partner with China's emerging omnichannel players.

Another striking difference between winners and others is in decision rights. Winners place almost all commercial decisions—including setting price guardrails and launching new products—in the hands of local or regional managers, rather than the global brand leader or global franchise leader.

Winners invest in consumer insights and empower local leaders.



Note: Figures may not sum to 100%, because of rounding.

Source: 2017 Commercial Excellence Benchmarking

For the full article, see "Commercial excellence in China: Lessons from the top CPG companies," on McKinsey.com. Also see the related article, "How consumer-goods companies can win in Southeast Asia," on McKinsey.com.

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Who’s shopping where?

The power of geospatial analytics in omnichannel retail

Using advanced geospatial analytics, retailers can now quantify the true economic value of each of their stores across channels—and they’re uncovering surprising insights.

Alana Podreciks, Nathan Uhlenbrock, and Kelly Ungerman

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The wave of store closures across the US retail sector continues. In 2017 alone, more than 7,000 stores went dark, unable to withstand consumers' rapid migration to e-commerce, the explosive growth of direct-to-consumer brands, and the glut of retail square footage in the heavily overstored US market. Retail space per capita in the United States is 15 to 20 times that of other major developed markets. Customer traffic at malls has been steadily decreasing. Margins are declining in almost every retail category. Given these trends, it's becoming harder to justify keeping expensive brick-and-mortar stores open if they don't meet sales expectations. In the first half of 2018, retailers announced plans to shutter an additional 4,000-plus US stores.

Unfortunately, retailers often make the wrong decisions about which stores to close, thus inadvertently hurting their business further. They also overlook valuable opportunities to expand their market presence and unlock growth. The main reason is that they're using outdated metrics: many retailers continue to use a combination of trend analysis and "four-wall economics" to assess store performance—that is, they're still primarily taking into account the sales and profits that the store generates within its four walls, without considering its impact on other channels. This assessment then affects other decisions, including the store's payroll, labor coverage, and sometimes inventory selection. However, consumers today shop across channels: they might visit stores to look at products and then eventually buy them online, or they might research a product online and then buy it in a store. In this environment, the traditional four-wall metrics are, at best, incomplete indicators of a store's potential.

The most sophisticated retailers are now closely examining the interplay between offline and online customer decision journeys. They're taking an omnichannel view of store performance—allowing each store to "get credit" for all the sales in which it played a role, whether those sales happened offline or online. In doing so, retailers are getting a more accurate picture of each store's total economic value and making better decisions about their omnichannel presence. Their secret weapon? Advanced geospatial analytics.

Outside the four walls

Physical stores aren't going away. We estimate that in-store sales will still make up 75 to 85 percent of retail sales by 2025. That said, the physical store is no longer just a place to buy products. A store now plays several possible roles: it might serve as an experiential showroom for products, a fulfillment center for online orders (or a convenient place for returning or exchanging online purchases), a hangout where groups of friends can try things on and take selfies that they then post on social media, or a destination for those seeking ideas and inspiration. It's entirely possible for a store to have weak sales and profits within its four walls while being a strong contributor to the retailer's overall performance.

Advances in data and analytics can help a retailer quantify both a store's halo effect (positive) and its cannibalization effect (negative)—in other words, how a store's existence influences the performance of the retailer's other sales channels (Exhibit 1). Retailers have long recognized that a store can have a halo effect, but it has traditionally been thought of in marketing terms—that is, a store can raise awareness of the retailer's brand, just like a billboard or a TV commercial. Viewed as such, the halo effect has been difficult to measure. However, in an omnichannel world, a store can do more than just raise awareness; it can drive sales through other channels, and vice versa. McKinsey research suggests that a store's e-commerce halo can account for 20 to 40 percent of its total economic value.

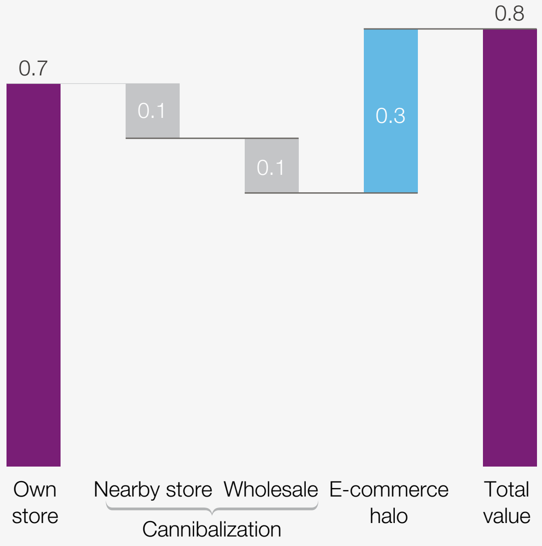
A new era in data and analytics

For decades, retailers have been mining a variety of data sets—point-of-sale information, demographics, market trends, and so on—to learn about customers and serve them better. Today, thanks to the availability

Exhibit 1 **Retailers can now measure the total cross-channel value of a retail store.**

Illustrative example

Cross-channel view based on consumer behavior and financial metrics, $ million



of new types and sources of data, it's possible for retailers to gain a much deeper understanding of consumers and markets. Retailers have access to more **consumer-behavior data** than they've ever had before, in the form of opt-in e-receipt programs and anonymized mobile-phone location data.

The aggregated data can shed light on not just the quantity but also the quality of customer traffic. This information allows retailers to get a detailed picture of how people move and interact within a market, as well as how they behave across both offline and online channels.

And it's not just that there are more data. Companies now also have access to **increased analytical horsepower** in machine-learning models. These models can mine big data assets and help generate granular, actionable insights at the micromarket level.

At the most sophisticated retailers, geospatial data and analytics are often owned by a strategic advanced-analytics group. The group, which can be centralized or reside within a specific function, drives the use of advanced analytics across silos. It delivers cross-cutting insights that bring together the priorities of various functions, including marketing, sales, finance, and real estate.

The combination of advanced geospatial techniques and machine learning, applied to cutting-edge data on consumer behavior, is unleashing powerful new insights for retailers. In particular, it's helping retailers make better decisions about expanding or contracting their store networks. It's also helping them develop store-level action plans to improve performance. In addition, some retailers are using these insights to mobilize their sales force and prioritize their investments.

Geospatial analytics in action: A case example

Consider the case of a global specialty retailer that sells its products through its own brick-and-mortar stores, an online store, and wholesale accounts. The retailer's sales were declining in the face of strong competition. For insights into how to reverse its sales trend across the network, the company turned to geospatial machine learning.

A team of data scientists built an analytical model customized for the brand, leveraging both internal and external data. Testing hundreds of variables, the team used geospatial machine learning to identify the factors that have the greatest positive or negative effect on a zip code's total sales (Exhibit 2).

Based on these drivers, the team was able to predict the retailer's potential sales in each zip code and each store, and to compare potential sales with actual sales. Then,

Exhibit 2

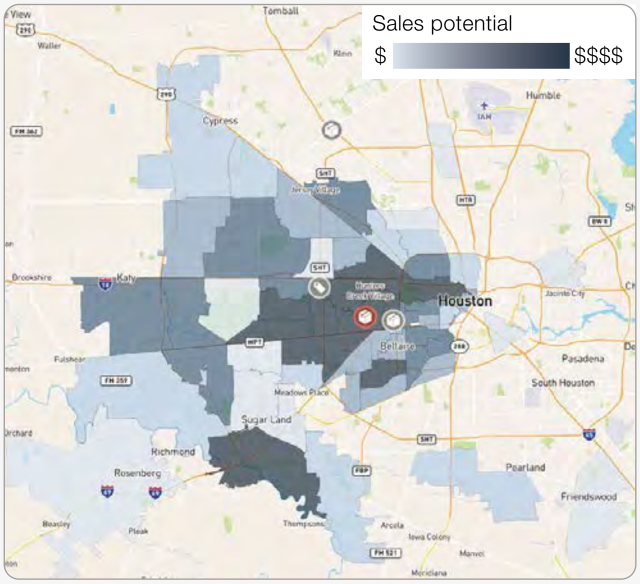
Using geospatial machine learning, a retailer identified the factors that most affect a zip code's sales potential.

Illustrative example

Sales drivers in every zip code, most important to least important

	Impact
Proximity to larger owned full-price stores	↑↑↑
High proportion of young urban professionals	↑↑↑
Primary competitor store within 5 miles	↓↓
High number of wholesale stores within 5 miles	↓↓
High store-manager ratings in nearest owned stores	↑
High online spend in category	↑
Low tourist spending	↓
High weekend foot traffic around nearest owned store	↑

Omnichannel sales potential by zip code, $



using geospatial simulation, it estimated each store's impact on wholesale and online sales.

The team was also able to isolate the unique factors that contribute to a strong e-commerce halo. It found that, in general, a store has a strong e-commerce halo if it is a larger store located in an area with a high proportion of young and urban professionals. Other factors that contribute to a strong e-commerce halo: being far from other same-brand stores, being in a high-traffic retail environment such as a high-quality mall or a power shopping center, and having low tourist spend (which means most of the store's customers live or work nearby).

The retailer used these insights to identify which stores weren't living up to their sales and profit potential (Exhibit 3) and which micromarkets represented untapped growth opportunities. Further analysis revealed that the retailer could optimize the omnichannel value of its store network and achieve a 20 percent gain in EBITDA by closing, relocating, or reformatting stores (for instance, turning a full-priced store into a digital showroom).

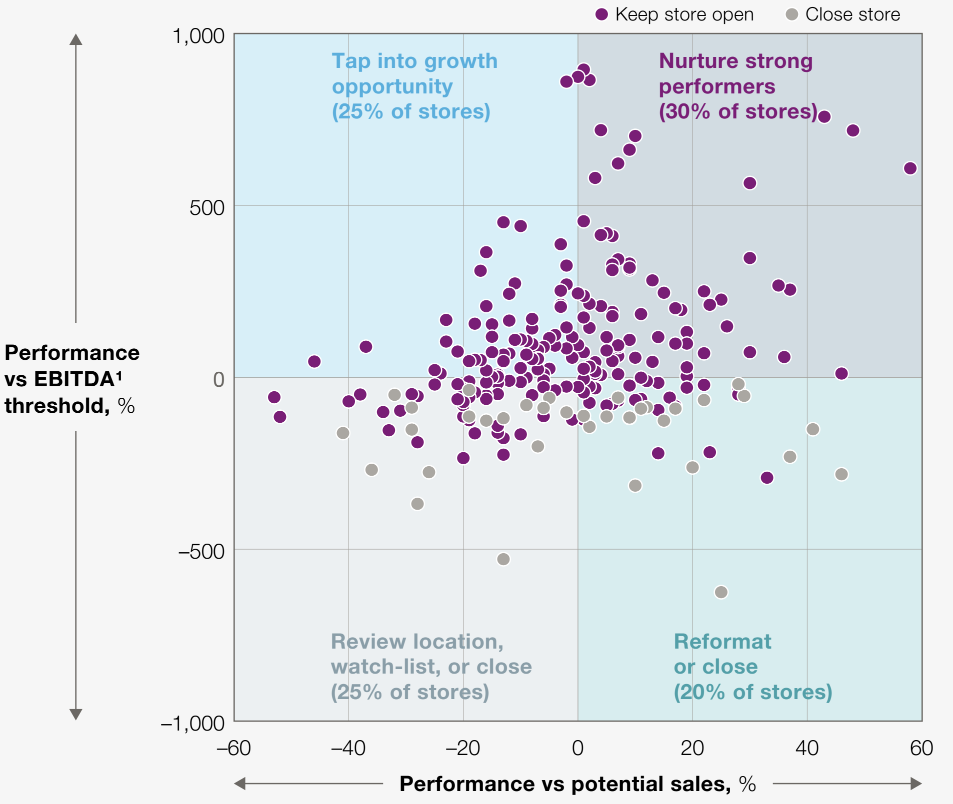
The retailer then created market-level "battle plans" for its store network: which stores to reformat or close, where to increase its presence either via new stores or deeper wholesale penetration, and what the sequence and scope of its investments would be.

Exhibit 3

A retailer can categorize stores into four groups based on sales potential and profitability.

Illustrative example

Profitability vs potential sales



[1] Earnings before interest, tax, depreciation, and amortization.

Source: McKinsey analysis

Getting started

In kicking off a geospatial analytics effort, every retailer will have a different starting point. We recommend that companies first conduct an internal inventory of data availability and advanced-analytics capabilities.

Some retailers have limited data (for example, low visibility into wholesale accounts), siloed business units, and only a handful of data scientists and analysts, if any. These retailers should build their minimum data requirements and consider partnering with external providers or acquiring analytics capabilities outright.

On the other end of the spectrum, some retailers already have extensive external data partnerships, consistent and reliable data-sharing processes with their wholesale accounts, and senior management focused on omnichannel success. Such retailers can opt to build a strong data-science team with experience in geospatial analytics. That team would


© VictorHuang/Getty Images

be tasked not just with performing the analyses but also with generating useful insights that can be easily integrated into real-time business processes and decision making.

Regardless of their "build, buy, or partner" decision, retailers must constantly strive to break down business silos. If the heads of the retail, e-commerce, wholesale, marketing, real-estate, and finance functions all operate independently of one another and have few or no cross-cutting goals or initiatives, the company as a whole won't be able to make the best omnichannel decisions.

■ ■ ■

In our experience, retailers can quantify performance gaps, uncover growth opportunities in their go-to-market strategy, and reap early wins from advanced geospatial analytics within 6 to 12 months—particularly when an empowered, cross-functional team is leading the charge. Successful pilots in one or two markets can quickly build buy-in for a global rollout. By harnessing the power of geospatial analytics, retailers can capture the omnichannel customer—which, in the near future, could very well be the only kind of customer there is. ■

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From lab to leader: How consumer companies can drive growth at scale with disruptive innovation

In the era of "fast products" and digital disruption, delivering growth requires putting in place new predictive consumer-growth capabilities—including innovation—based on speed, agility, and scale.

Mark Dziersk, Stacey Haas, Jon McClain, and Brian Quinn

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Innovation is central to the mission, values, and agenda of most consumer-packaged-goods (CPG) companies. However, in the past several years, incumbent CPG companies have struggled to keep pace with start-ups, which have reinvigorated and reinvented categories ranging from ice cream to diapers.

Our analysis of the food and beverage market from 2013 to 2017 reveals that the top 25 manufacturers are responsible for 59 percent of sales but only 2 percent of category growth. Conversely, 44 percent of category growth has come from the next 400 manufacturers.[1] Our experience in working with large consumer companies suggests that they don't suffer from a lack of ideas; where they struggle is in knowing where to make bets, moving products quickly to launch, and then nurturing them to scale. Effectively driving growth through innovation requires CPG companies to evolve many of the assets and capabilities already in place and adopt significantly different and new ways of working.

These changes will not be easy. Many of the innovation systems that need to evolve are deeply entrenched. They have their own brand names, dedicated IT systems, firmly established management routines, and more. However, our work with CPG organizations has convinced us that these changes are necessary and can return significant value.

Our analysis of approximately 350 CPG companies across 21 subcategories found that growth leaders excelled at harnessing commercial capabilities, including innovation. Additional McKinsey analysis has shown that CPG "creator" companies—those that consistently develop new products or services—grow more than their peers. These winning creators have adopted a formula that borrows the best from progressive new players while fully leveraging existing advantages in scope and scale.

How did we get here?

For the past two decades, CPG innovation models have been designed to maintain and grow already-at-scale brands. This meant that most innovations were largely incremental moves, with the occasional one-off disruptive success. This slow and steady approach worked because CPG companies didn't really need disruptive innovation to grow. Geographic expansion, pricing, and brand extensions were all successful strategies that kept the top line moving. As a result, most of the systems designed to manage these innovations were optimized for fairly predictable and low-volatility initiatives. They emphasized reliability and risk management.

That very success, however, led to calcified thinking as companies built large brands and poured resources into supporting and protecting them. In recent years, as CPG companies have tried to respond to new entrants and rapidly changing consumer needs, they found that their innovation systems tended to stifle and stall more disruptive efforts. As the returns from innovation dwindled, companies cut marketing, insights, and innovation budgets to cover profit shortfalls. This created a negative cycle. As a stopgap, many large consumer companies have turned to M&A to fill holes in the innovation portfolio—but on its own, M&A can be a very expensive path to growth with its own difficulties in scalability and cultural fit.

How upstarts "do" innovation—through speed, agility, and a consumer-first approach—is not exactly a secret. Many CPG companies have made concerted efforts to embrace those attributes by setting up incubators, garages, and labs. They have tried to become agile and use test-and-learn programs. But while there have been notable successes, they tend to be episodic or fail to scale because they happen at the periphery of the main innovation system or even as explicit "exemptions" from standard processes. Scaled success requires making disruptive innovation part of the normal course of business.

What to learn from today's innovators

Despite the many challenges, there are consumer companies winning in the market and driving profitable growth. Here are four shifts they're making.

1. Focus on targeted consumer needs

All of us can think of innovative products that are competing head to head in established categories (some include Halo Top Creamery, SkinnyPop, and Blue Buffalo). A common denominator for most of them is that they didn't start big but focused instead on a targeted and unmet consumer need that turned out to have broad reach.

That approach stands in stark contrast to the standard CPG model, in which companies look for the products that satisfy the largest group (the general population, or "gen pop"). An important reason for this focus is that many CPG companies need an idea to be big enough to make a dent in their business. They also look to get the highest return on investment for innovations to amortize the high costs historically required to launch (especially ad campaigns and capital expenditures for new manufacturing). But in a world where it is less expensive and easier than ever for companies to address more targeted needs, and where consumers have never had more choices at their fingertips, satisfying the gen pop is becoming less and less viable as an objective or requirement.

This isn't to suggest that large CPG companies should stop looking for substantial and growing opportunities. But the evidence is clear that there are plenty of products that start small—and would normally be killed off at a large CPG company—but explode once in the market.

All strong innovation begins with the ability to identify a consumer need that the marketplace isn't addressing. That happens through actions such as the following:

- *Exploring granular consumer needs with advanced analytics.* CPG leaders explore opportunities through highly granular, data-rich maps of product benefits, consumer needs, and usage occasions rather than just segments or categories (we call these "growth maps"). These can reveal how a seemingly niche and emerging trend could have surprisingly broad reach and applicability.

- *Combining many data sources to address tipping-point trends quickly.* Leaders combine various types of data (such as consumer, business, and technology data) from a range of sources to identify market trends that are hitting relevant tipping points. They understand where the most promising trends are, where they have the capabilities to play, and where they might need to build new muscle. And they bring all this together to rapidly prioritize where to take action.

- *Using design thinking.* By using empathy to uncover unspoken and unmet needs, designing new solutions with consumers and channel partners, and rapidly prototyping and testing, design thinking produces distinctive answers.

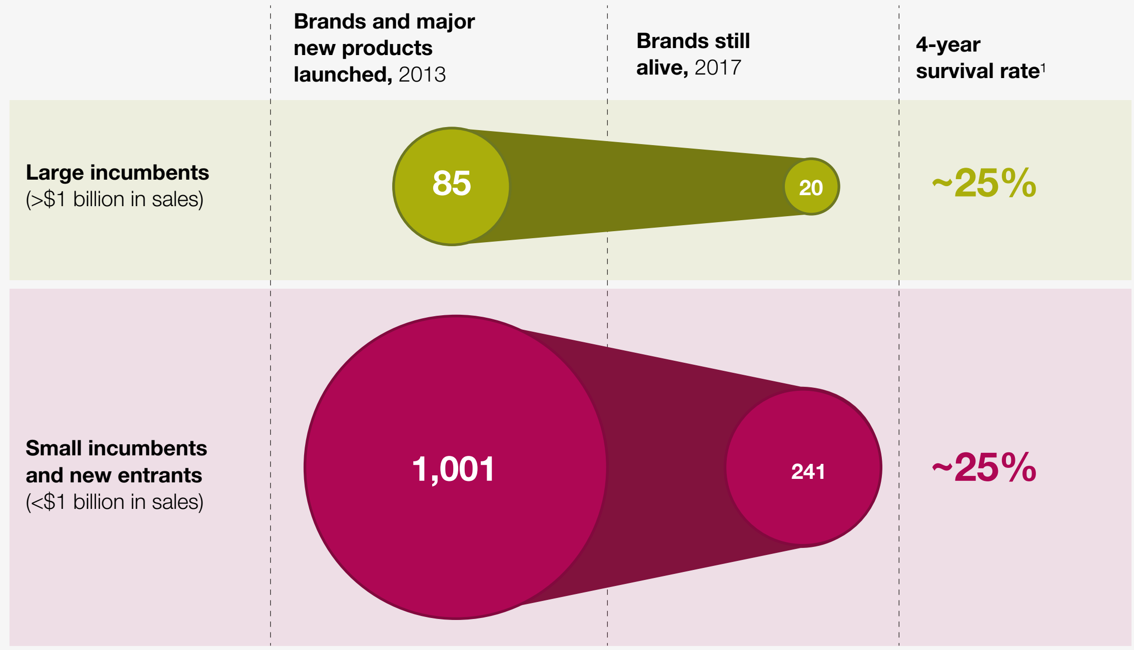
Importantly, true design thinking continues to incorporate consumer insights and iterate product designs even after initial product launch. Two leading consumer companies in Japan recently set up "innovation garages" to integrate design thinking into product-development methods. They were excited by the power of this integration to produce better, more consumer-driven products radically faster.

2. Launch more "speedboats"—accepting that some of them will sink

There is a prevailing myth that consumer companies need to do a few big launches a year. Even if that were once true, it no longer is. That approach required large R&D investments, extensive consumer testing to validate willingness to purchase, and massive resources (such as large advertising, promotion, and distribution budgets)—all in an attempt to predict success and perfect a product before a large, potentially multicountry launch. This mentality assumed the resulting product could not fail once it hit the open market.

Exhibit 1 **The ‘few big bets’ approach by large incumbents has not improved outcomes—winning requires getting more products successfully into market.**

Packaged food, US, 2013–17



[1] Based on brands available and fulfilled by Amazon in Aug 2017 and/or recognized by market reports as share leaders.

Source: Euromonitor; Mintel GNPD; McKinsey analysis

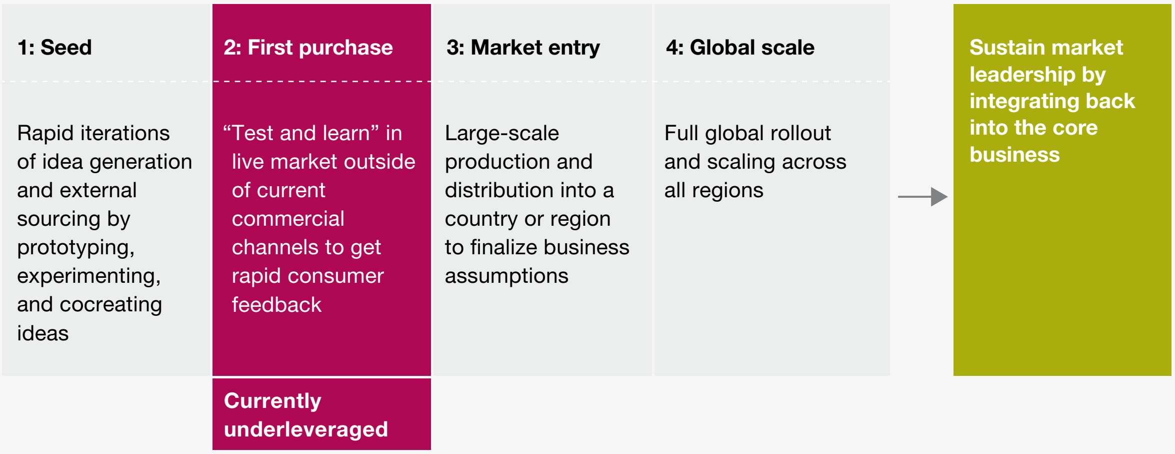
However, our findings suggest that putting all this effort and funding to drive a successful launch has not actually provided the desired results. In packaged food, for example, a review of new brands and disruptive innovations launched in 2013 by large CPG companies found that only 25 percent were still around four years later. This success rate is no better than what start-ups and small CPG companies achieved with much smaller budgets and programs (Exhibit 1).

Winning innovators, in contrast, increasingly rely on speedboats: smaller launches in which the product is tested and refined in-market. Take the example of one global CPG company that is extensively using “first-purchase testing” to understand why consumers are or are not purchasing a product, then integrating that feedback into further iterations (Exhibit 2). It has been testing real products in multiple nontraditional settings, including office buildings, juice shops, and yoga studios. The insights gained from these live settings allow the company to iterate the product design quickly. Once indicators of success are seen, it moves to scale the product rapidly via Amazon and traditional retailers. The approach works, because in today’s ecosystem, there are many distribution channels and digital and social-media outlets to reach consumers less expensively as well as external networks that can support efficient and productive discovery and development.

The internet also provides an underutilized testing ground for speedboats. Many disruptive brands start by marketing directly to consumers, which allows them to hone the product and messaging while capturing detailed data on purchase behavior. Even

Exhibit 2

Leaders work differently within and across four distinct phases for breakthrough success.



1: Seed

Rapid iterations of idea generation and external sourcing by prototyping, experimenting, and cocreating ideas

2: First purchase

“Test and learn” in live market outside of current commercial channels to get rapid consumer feedback

Currently underleveraged

3: Market entry

Large-scale production and distribution into a country or region to finalize business assumptions

4: Global scale

Full global rollout and scaling across all regions

Sustain market leadership by integrating back into the core business

without e-commerce, most start-ups are heavily using social media to reach targeted audiences with lower cost and risk.

More speedboats, however, can mean more headaches for general managers who must keep track of more projects and then nurture products to scale. CPG leaders address this through strong portfolio management. They make clear, prioritized choices about which categories and segments they will innovate in and which ones they will maintain or exit from. They put in place clear processes for tracking performance and new allocation mechanisms to get funds to promising programs quickly. And when they need to scale new bets, they fund them by reinvesting initial proceeds from the speedboats.

3. Think (and act) like a venture investor

Traditional stage-gate processes are very efficient for managing a large pipeline of similar ideas through a relatively standard development pathway. However, when used for more disruptive initiatives, stage-gate processes tend to systematically smother or starve them. A different system is required for disruptive innovation.

Consider how venture-capital firms manage their portfolio of investments. They analyze each investment on its own merits, adapting as businesses evolve. They couple funding closely to the progress of the new business and meet at the speed of its progress versus on a predefined calendar. The hurdle rates and key performance indicators are also different, with emphasis on whether the business is gaining consumer traction in addition to improving financials. And more than anything, venture investors are relentless in pushing the pace and urgency of growth.

For companies to deliver on this capability, we often recommend that they establish their own venture board comprising their strongest leaders. Even though the scale may be small, this is some of the hardest work in the company and the most important to its future. Along with a few outsiders to inject a more objective perspective, this board is responsible for maximizing the return of the more aggressive portfolio—and has complete autonomy to quickly make decisions about it.

4. Understand that first to scale beats first to market

Launching disruptive innovation doesn't mean a company must always be the original inventor. Rather than focusing on being first to market, companies should focus on being first to scale. We found that leading CPG innovators that actively scan the market for high-potential ideas, watch for emerging consumer acceptance and new behaviors, and then jump in before the market landscape has fully evolved have reaped significant rewards. We evaluated 25 high-growth categories in four countries across Asia, Europe, and North and South America. In each, the players who took this approach are winning approximately 60 to 80 percent of the time; in the United States, they win the highest market share 80 percent of the time.

Incumbent CPG companies can turn to their ingrained advantages to identify and scale these ideas. Their wealth of consumer data can be used to spot trends earlier than others. Their significant financial and human resources can be disproportionately allocated to hot opportunities. Since they have distribution and account relationships with multiple retailers, incumbents can expand the market for new products more easily and quickly than new players, with a smaller network of relationships, can. Large CPG companies are also attractive partners for innovators with insightful ideas but insufficient resources to develop and scale them.

Many smaller players would love to acquire incumbents' advantages. Using these advantages to their fullest requires CPG companies to adopt a much stronger orientation toward speed, nurture more disruptive bets until they can be scaled, and reallocate resources to the biggest opportunities.

How to get started

Embracing the shifts we describe will require meaningful changes. In our experience, the changes are not only eminently achievable but also serve to reenergize the organization as they make innovation and delighting consumers more central and less cumbersome to accomplish. We recommend CPG leaders do five things now.

1. Address the culture

Business leaders understand how important culture is but tend to think of it as a vague by-product of other activities. Building an innovation culture begins with making innovation essential to the day-to-day business, and it's critical that it start at the top, with the CEO and senior-executive team. As one consumer executive—who grew her company to a billion-dollar valuation in fewer than 15 years—put it, "Innovation is simply everyone's job.... Everyone is expected to look for insights, to bring ideas, to be ready to help drive an initiative." Other ingredients include a near-maniacal focus on the consumer—by which we mean putting the consumer at the center of every decision; incentives to reward innovation; metrics that track innovation—such as consumer excitement, word of mouth, and adoption rates; and a clear understanding of how each person's role adds value to the process. Companies should reward learning and make lessons easily available and shareable.

2. Create high aspirations and hard metrics

"Let's increase growth by 2 to 3 percent!" That kind of aspiration won't motivate people and drive new thinking. Contrast that rather vague hope with

Launching disruptive innovation doesn't mean a company must always be the original inventor. Rather than focusing on being first to market, companies should focus on being first to scale.

this one from a mining company: “Generate $150 million of incremental earnings before interest, taxes, depreciation, and amortization over the next five years by discovering new applications for our products, moving closer to our end customers, and leading our industry in production processes.” This is bold, actionable, and measurable and gives teams some sense of where and how they should innovate. To track progress against aspirations, metrics need to be specific, of course, but they also need to evolve.

For example, metrics on market share or growth rate will be better in the earlier phase of a product’s life cycle. Shift the focus to value and margin as the project scales and matures. Metrics also must be in the business-unit leader’s performance objectives.

3. Define the hunting grounds

Make clear choices about where you will innovate. Be careful to define them by working backward from the consumers and markets you serve rather than the way you currently define your brand and category structures, particularly in multibrand organizations. Too often we see outdated guardrails unnecessarily limit brands from exploring new spaces. As one CEO, whose company was acquired by a leading global CPG incumbent, put it, “If your consumers want your brand to move into a space and you don’t [do so], then rest assured, someone else will.”

4. Reallocate resources

In our experience, most incumbent CPG companies have too many resources committed to initiatives that are unlikely to drive meaningful growth. The first step in liberating resources is to take a hard look at the portfolio and reallocate people to more aggressive growth opportunities. Crucially, this cannot be an annual or even quarterly exercise. Leading innovators continually and ruthlessly reallocate resources and make sure scarce people and dollars are put to the best use. As one innovative CPG leader in Asia–Pacific said, “I established three simple mandates: bigger (more top-line potential), better (more differentiated), and faster (shorter time to market).” These mandates drove top-line growth at four to five times the underlying category growth.

5. Put a new disruptive innovation system in place based on agile models

Driving success at scale requires a new model. Innovative ideas can initially generate a lot of excitement and promise. But that drive often wilts when it needs to work with the full business to scale the idea. While there is a broad range of elements in a new innovation system, we find that the following are a few of the most important:

- *Establish cross-functional teams with a complementary set of problem-solving skills.* These skills can include expertise in insights, marketing, personnel, sales, user experience, and tech. The team should “live” together, using an agile development model, and ideally drive one to two initiatives at any given time.

- *Focus on constant learning and “derisking” throughout development.* Rather than use a standard checklist of activities and stages, teams should constantly identify and prioritize the greatest uncertainties in a concept and conduct quick tests to resolve them.

- *Set up and prequalify your speedboat network.* This network can include factories, partners, agencies, and vendors who can support small-scale procurement and manufacturing, run first-purchase tests, and even support a riskier new product’s first few years of manufacturing before committing the capital expenditure for scaled or global manufacturing.

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- *Build in points of contact between the innovation labs and the "mother ship."* Embed people from the sponsor business unit as core parts of the innovation team, and rotate people from the main business through the innovation labs. Assign respected leaders from the legacy business to manage innovation projects. Create a central innovation road map that business units agree on, and track it on the CEO or COO agenda.

■ ■ ■

The growth game has changed, but that doesn't mean that CPG companies can't change with it. With a commitment to new mind-sets and approaches, CPG companies can harness speed and agility to move again to the forefront of innovation. ■

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[1] McKinsey analysis of Nielsen Total US All Outlets Combined channel data, 2014–17, US CPG manufacturers—food, beverage, personal care, and household care.

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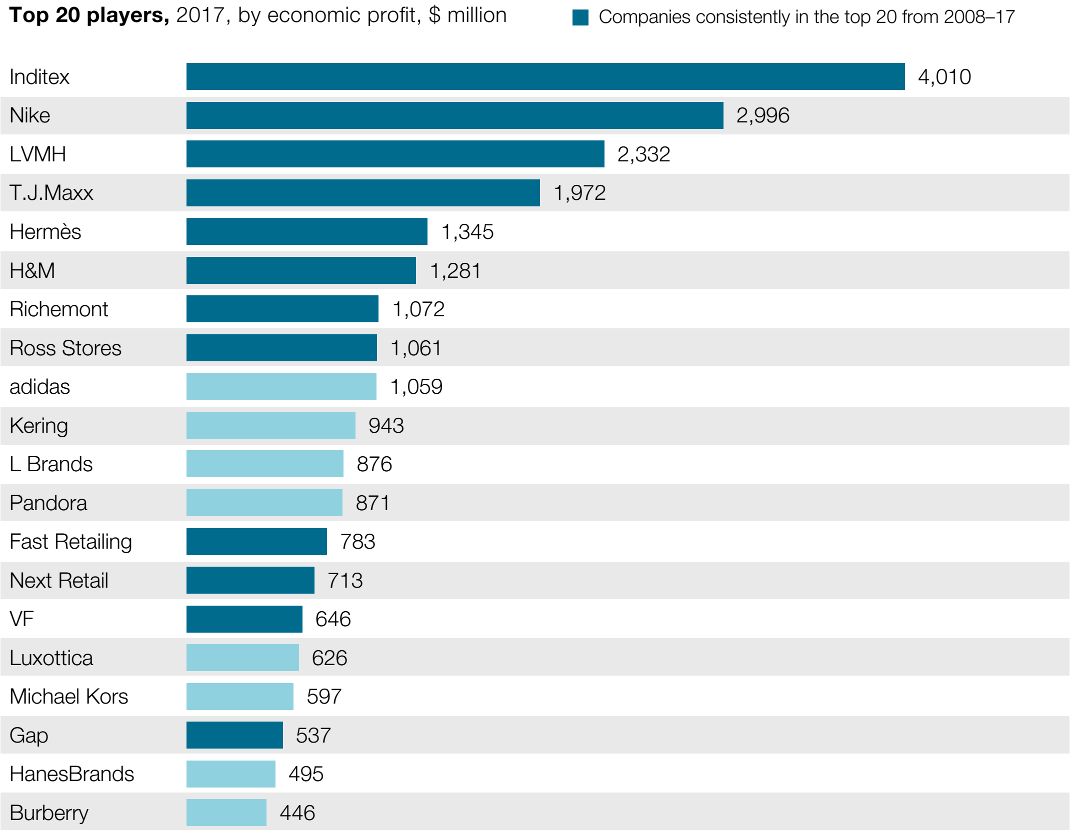
2019: A year of awakening for the fashion industry

Anita Balchandani, Achim Berg, and Saskia Hedrich

There's a shrinking group of "superwinners" in the fashion world. As we explain in our new report, *The State of Fashion 2019,* the top 20 fashion companies now account for 97 percent of the value created in the industry, compared with 70 percent in 2010. Long-term leaders include Inditex, Nike, and LVMH (Exhibit 1), each of which more than doubled its economic profit over the past ten years. Looking ahead to 2019, it's likely that the gap between winners and all other players will widen further.

Exhibit 1 **Among the top 20 players by economic profit, top-ranked Inditex made almost ten times as much profit as Burberry, ranked 20th.**

Top 20 players, 2017, by economic profit, $ million

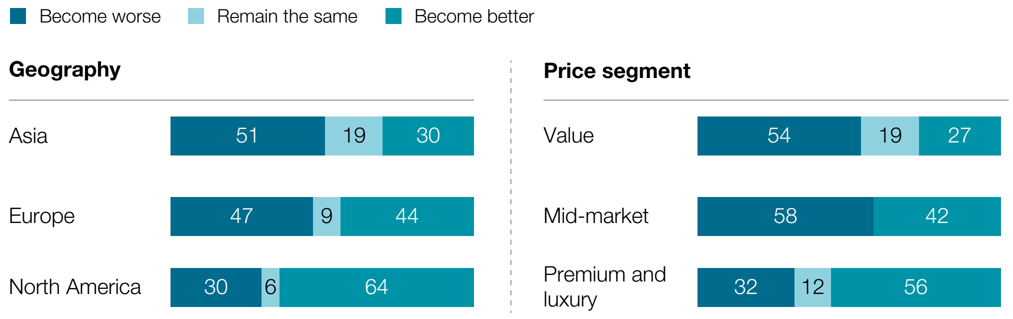


Source: McKinsey Global Fashion Index, based on data from McKinsey Corporate Performance Analytics

Overall, we forecast growth in the fashion industry to slow down to a rate of 3.5 to 4.5 percent in 2019. Most fashion executives are bracing for tougher times, with 70 percent saying they're pessimistic about the global economic outlook in 2019. Many expect business conditions in the fashion industry to worsen in the coming year (Exhibit 2).

Exhibit 2 **Optimism is highest among fashion executives in North America and in the premium and luxury segment.**

"How will conditions evolve for the fashion industry in 2019?," % of respondents



Source: State of Fashion Survey, a joint survey conducted by McKinsey and the Business of Fashion, September 2018

Given the high level of uncertainty, fashion companies must invest in enhancing their productivity and resilience. They must make 2019 their year of awakening—and come to terms with the fact that the old rules no longer apply. Regardless of size or segment, fashion players now need to become nimble, think digital-first, and increase speed to market. They need to take an active stance on social issues, satisfy consumer demands for radical transparency and sustainability, and, most important, have the courage to "self-disrupt" in order to win new generations of customers.

For the full report from McKinsey and The Business of Fashion, see *The State of Fashion 2019,* available for download on McKinsey.com.

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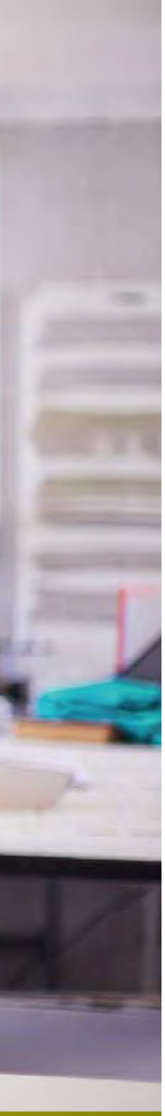
The authors wish to thank Johanna Andersson, Marco Beltrami, Dale Kim, and Felix Rölkens for their contributions to this article and to the full report.

Faster fashion: How to shorten the apparel calendar

To get new styles into stores more quickly, fashion companies must improve internal collaboration, tap into consumer insights, and start to digitize the value chain.

Achim Berg, Miriam Heyn, Felix Rölkens, and Patrick Simon



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When Burberry and Tom Ford began experimenting with the fashion-industry concept known as "see now, buy now" in 2016, their efforts were met with a little skepticism and a lot of excitement. The thinking was that consumers, especially millennials, have become accustomed to instant gratification and are therefore much less willing to wait several months to own the latest runway styles. The "fast fashion" companies—the likes of Forever 21, H&M, Inditex, and Primark—were already producing replicas of fresh-off-the-runway items and selling them in stores in a matter of weeks, and consumers were rewarding their speed to market: revenues at those companies rose 8.2 percent in 2017 in aggregate, whereas overall apparel retail grew only about 3.5 percent in that same period.[1] With a "see now, buy now" sales model, luxury fashion companies, too, could capitalize on the media coverage surrounding Fashion Week events in New York, London, Milan, and Paris, and translate the buzz into full-fledged sales campaigns.

But skeptics wondered whether "see now, buy now" could work for higher-end apparel. Indeed, it hasn't been an unqualified success. A handful of designers, including Tom Ford, have since reversed course, citing the misalignment between the timing of Fashion Week and store shipping schedules. Still, more than 15 leading fashion companies are continuing to experiment with "see now, buy now." Is it a feasible model for the long term?

Our answer is yes—so long as fashion companies are willing to embark on a dramatic transformation of their processes and mind-sets. Shortening the fashion cycle isn't a quick-fix undertaking.

The phases of the fashion cycle

Broadly speaking, the fashion cycle consists of three phases: planning, design, and product development; sell-in; and production and delivery. The length of each phase varies widely by company. A phase can be as short as 12 weeks or as long as 30. The planning, design, and development phase is typically the longest and has the widest variability among companies (exhibit). Therefore, that's where the greatest potential for compressing the calendar lies.

The length of the end-to-end fashion cycle depends on a number of factors, including the company's business model and retailer requirements for the assortment. For example, vertically integrated players (such as H&M and Zara) can make decisions faster and skip the sell-in phase because they operate their own stores. Even within a brand, different product groups might follow different calendars: women's tops are typically refreshed more frequently than women's jeans, for instance. Basic items (such as plain white T-shirts) don't have to follow a seasonal collection rhythm because sales of such items are fairly consistent and easier to predict. Still, some basics retailers—Uniqlo, for one—are constantly finding ways to shorten their fashion cycle.

Speeding up each phase

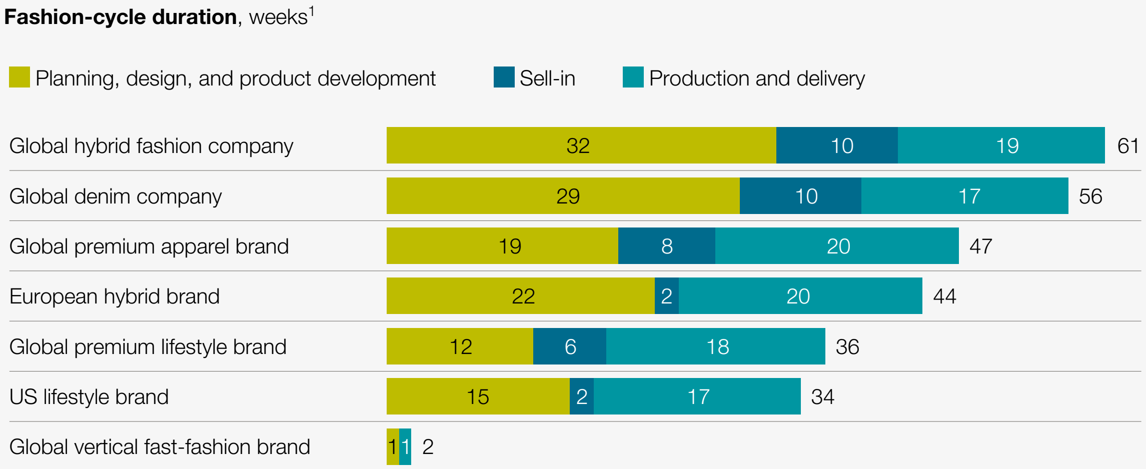
To shorten time to market, the first step is to define a viable target length for the full fashion cycle, taking into account the company's business model, retailer requirements for the assortment, and benchmarks from competitors—especially those that have successfully shortened their own calendars. Once the target length for the full cycle has been set, the next step is to eliminate time-wasting activities and accelerate processes in each phase.

Planning, design, and product development

In this first phase, the finance team sets financial targets for the collection while the creative teams for each division (such as women's, men's, and children's) determine the creative direction of the season's collection: What narratives or themes will the collection embody? What will be the overall look and feel? What fabrics and color palettes will it feature? The creative teams also develop a master plan specifying the breadth and depth of their respective collections, along with price ranges. An example: the Spring 2019 menswear collection will have 12 styles

Exhibit

The duration of an end-to-end fashion cycle varies widely by company.



[1] Approximate.

of pants—four each in shorts, casual khakis, and dress pants—all in the $85 to $95 range.

At some apparel companies, the finance and creative teams work separately, with each team unaware of what the other is doing. This often results in inefficiencies and rework. Leading-edge companies have instead established a central merchandising team composed of staff from both the financial and creative sides of the business. This team collaborates on the creative direction, the financial targets, and the master plan; they agree on parameters early in the fashion cycle. This collaboration can cut out unnecessary iterations and shave up to five weeks off the initial phase.

The central team typically reviews sales data from the previous year, which can yield valuable consumer insights and form the basis of sensible business constraints. Advanced analytical tools and techniques can help increase the reliability of forecasts by isolating the factors that drove sales, down to the SKU level: Did a particular shirt sell well because of its color? Cut? Logo design? Was it especially popular in a certain city or neighborhood, or with a specific type of customer? The most forward-looking companies analyze additional types of publicly available data such as online searches, social media, competitor websites, and online product ratings. These analyses not only unearth nascent trends but also warn of receding trends. Some fashion companies have even begun experimenting with natural-language processing and visual processing, although these technologies can’t yet reliably translate text or images (for example, from tweets or Instagram posts by influencers) into clear, actionable insights.

Generating consumer insights is one thing; instilling a culture of insight-driven decision making is quite another. It represents a major change, particularly for fashion companies, which tend to see their business as creative rather than data driven. The most successful companies are those that strike a balance between art and science. They invest in advanced-analytics systems and tools and, just as important, they ensure that there are "translators" and "connecters" within the organization—people who are data savvy, thoroughly understand the company's business processes, and have credibility among all internal decision makers—to bridge the gaps between analysts and designers.

Armed with data and insights, the company then produces the first prototypes of the new collection. We've found that this process can be compressed by up to three weeks if the company opts to create mostly digital prototypes rather than physical ones.

Sell-in

Digital prototypes, which are 3-D images on a screen, can shorten the sell-in phase as well, by lessening the need for producing and shipping physical samples. With digital prototyping, fashion companies can showcase the collection to smaller retailers remotely; those customers can then place their orders without having to travel to a showroom at all. For larger customers, fashion companies can create a few physical samples but show most of the collection via customized digital showrooms.

Initially, buyers may balk at being shown digital prototypes instead of being able to touch, feel, and try on every item in the collection. But we've found that buyers come to appreciate the fact that 3-D design allows them to give more input into the design process: their suggestions can be incorporated into the designs right away. Many more colors, cuts, and styles can be tested and prototyped.

Digital prototyping is fast and scalable. Using body scans of human models, 3-D technology can show sizing, fit, and how the garment would look on a person. It becomes even more attractive as the technology

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Sprinting toward a shorter fashion cycle


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One company aimed to shorten its fashion cycle from 60 weeks to 44, largely by digitizing the value chain. To do so, the company used an agile approach—a way of working that more closely links conceptualization to implementation through "sprints," or fast-paced units of progress. The idea of a sprint, aside from moving quickly, is to constantly readjust so that each successive sprint yields better results.

The company treated each season as a series of agile sprints. Prior to each sprint, the team defined the elements that would be tested. For instance, one test involved digital design and prototyping of one product group. The test was conducted in only two of the four divisions, on a strict timeline following a "freeze and release" logic. After each sprint, the team would discuss what the obstacles and pain points were and agree on how to do things differently in the next sprint, which would have more ambitious targets. In one sprint, designers felt that the design software was too slow, the rendering of images was poor, and the library of fabrics was too limited. A cross-functional team of designers, process experts, and IT specialists worked together to address these pain points.

The company not only achieved its goal of a 44-week calendar—a goal that some in the organization initially felt was unreachable—but it also produced a smaller and less complex assortment. On-time availability and production planning improved as well, thanks to better forecasting that allowed the company to book factory capacity ahead of time.

improves and renderings become more detailed and truer to life (see sidebar, "Sprinting toward a shorter fashion cycle").

Production and delivery

Opportunities for shortening the production and delivery phase are fewer but still meaningful. One lever is disciplined manufacturer management. Leading fashion companies have so tightly integrated their manufacturing partners into their business that manufacturers take responsibility for a variety of tasks and approvals. In some cases, manufacturers bypass several sign-offs from the head office, thereby cutting as many as ten days from the production process. In other cases, fashion companies have placed specific tasks (such as quality control) on-site at the factories, eliminating the need to ship samples and products back and forth between factory floor and design studio or corporate office.

As for capacity planning and booking, the earlier and the more detailed, the better. At many companies, the design teams for various divisions each have their own schedule and process for informing vendors of their needs for fabric, materials, and factory capacity. By contrast, at best-practice companies, a central supply-chain planning team consolidates orders from across the divisions. Much as a central merchandising team helps shorten the planning and product-development phase, a central supply-chain team helps compress the production phase. The team can approach vendors with a single view of what the company's needs are, as early as six months in advance of production.

Another lever for shortening the production phase is standardized vendor-management tools and interfaces. Currently, fashion companies use a mishmash of legacy systems, making vendor management cumbersome; a lack of standardization results in wasted time and rework. Each system asks for different inputs in different formats, so the inputs are often incomplete or inaccurate. Companies that have moved toward a single, intuitive product-life-cycle management tool—one that can accommodate sketches, photos of comparable products, and many types of product information (on fabric, fit, color, and so on)—have seen tremendous benefits.

■ ■ ■

Traditional fashion companies must be willing to not just make cosmetic changes to their calendars but also thoroughly examine each of their activities and processes. They must also be willing to effect a change in mind-sets across the organization. In doing so, they could give the fast-fashion companies a run—maybe even a sprint—for their money. ■

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[1] According to the 2017 McKinsey Global Fashion Index and company annual reports.

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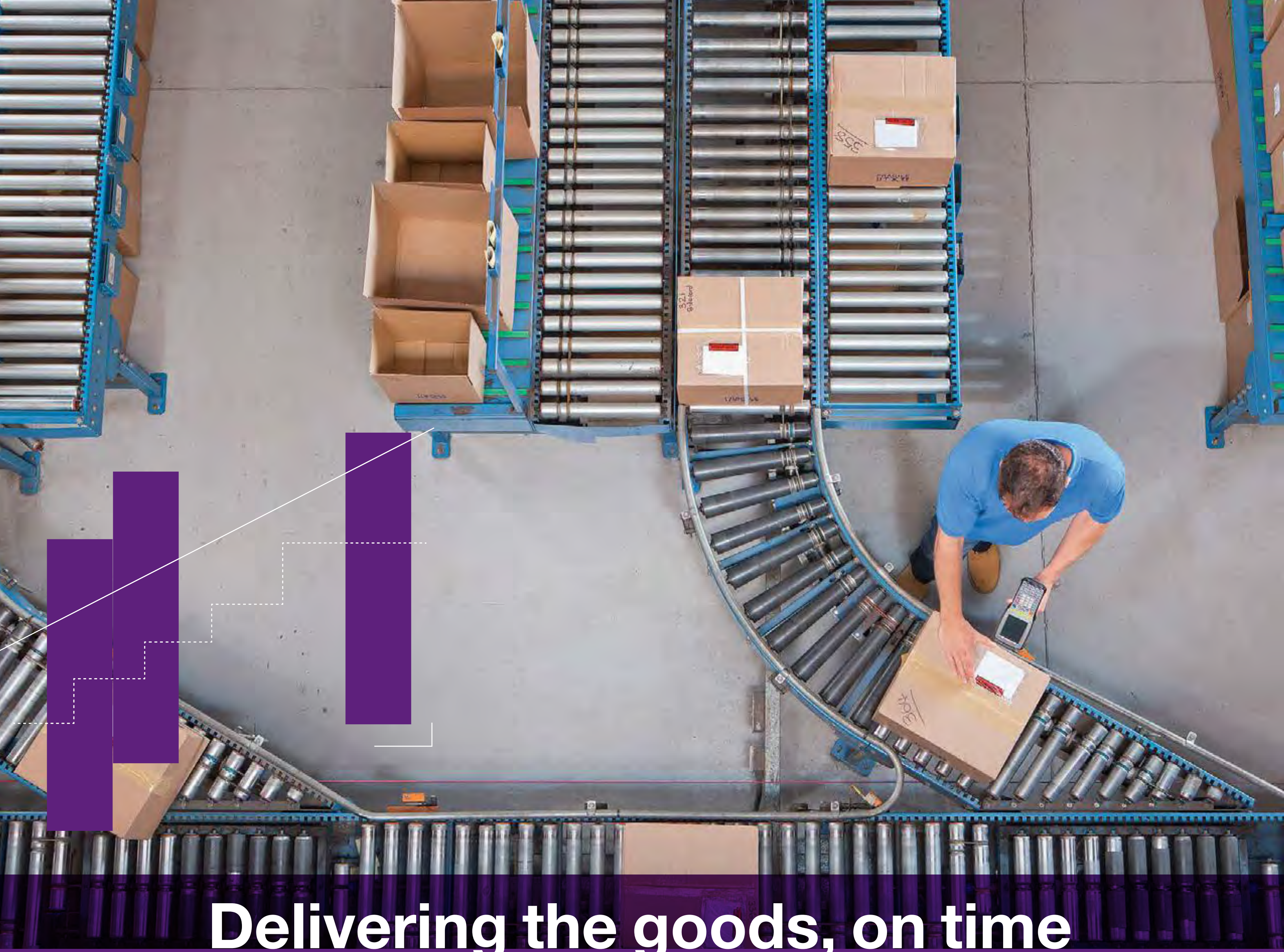

Delivering the goods, on time and in full

E-commerce giants have raised the bar for supply-chain performance. Now consumer-goods manufacturers face a stark choice: achieve new levels of accuracy and responsiveness, or pay a heavy price.

Christoph Kuntze, Adrian Martin, Colin Regnier, and Ildefonso Silva

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As of mid-2018, approximately 60 percent of Amazon's US customers were members of the company's Prime premium delivery service. Those 95 million consumers are worth a lot to the e-commerce giant; on average, they spend $1,400 a year with the company, compared with the $600 spent by nonmembers. In return, they expect exceptionally high service levels. A key benefit of Prime membership is two-day delivery at no additional cost.

To meet its service promises, Amazon has invested heavily in logistics infrastructure. As of July 2018, the company operated 122 fulfillment centers in the United States, with another 44 planned or under construction. The opening of those facilities will take Amazon's US warehouse space beyond 100 million square feet (9.29 million square meters). The company's distribution network isn't just big—it's also remarkably high performing. Amazon's network operates with a third fewer days of inventory than most major conventional retailers. Items are picked, packed, and ready to ship two hours after a customer order is placed. Amazon is also at the forefront of the large-scale application of robotics and automation systems in warehouse operations.

Where Amazon has led, the rest of the industry is following rapidly. Walmart is developing a network of dedicated e-commerce distribution centers designed to allow next-day delivery of online orders to 90 percent of the US population. Other top retailers are making big investments to secure their position in the online space, acquiring e-commerce rivals and same-day logistics players as well as developing their internal fulfillment capabilities.

Retailers put suppliers under pressure

As they ramp up their own service levels, retailers expect their suppliers to shoulder some of the burden. Leading retailers are tightening supplier service expectations and imposing stiff financial penalties for orders that are incomplete or that miss agreed-on delivery windows. Kroger fines suppliers $500 for each order delivered more than two days late, for example, while Walmart charges suppliers 3 percent of the purchase price for every order delivered early, late, or incomplete. Both retailers have also narrowed the delivery window for full truckloads from four days to one or two.

As these sanctions become the norm across the industry, they could create real pain for suppliers. Our analysis suggests that penalties could add up to more than $5 billion a year across the United States, if the consumer-packaged-goods (CPG) sector doesn't improve its current delivery performance. Individual CPG players could see their margins cut by a full percentage point.

To compound these challenges, order complexity is rising alongside service requirements. One way online retailers compete is by offering their customers a much wider selection than traditional brick-and-mortar stores. As early as 2014, Amazon's most important US distribution centers already held more than five million SKUs, for example. CPG players struggle with complex orders: case-fill rates and on-time, in-full shipments decrease sharply as the number of unique line items in an order goes up (exhibit).

Supply-chain performance makes the difference

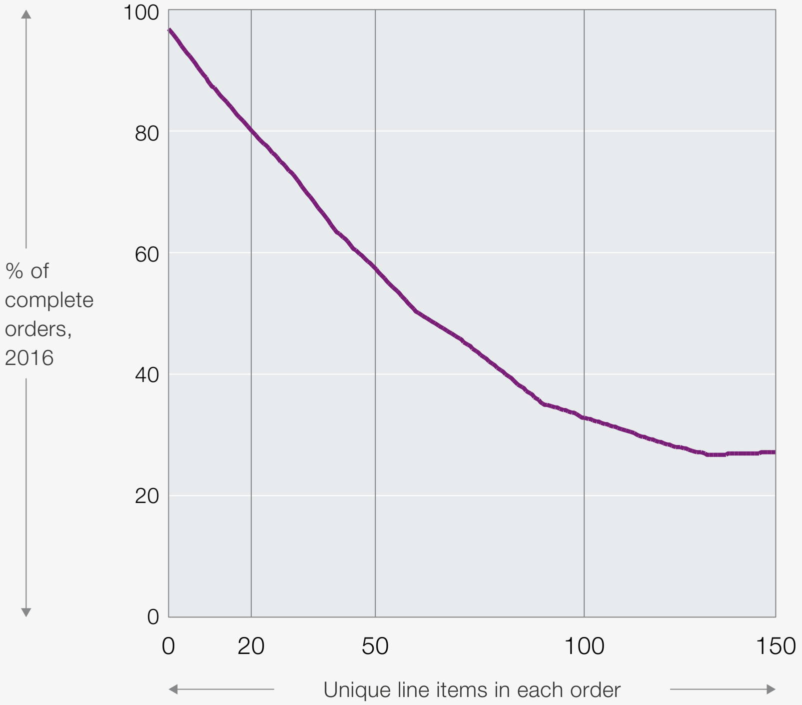
This high-complexity, high-service world is an uncomfortable prospect for consumer-goods manufacturers. Yet it also offers a significant opportunity. Companies that can upgrade their supply-chain performance to meet or exceed the expectations of retailers won't just avoid painful penalties—they will also have the opportunity to get ahead of their rivals by capturing market share in increasingly important online channels and by securing preferred-supplier status with major customers.

Achieving on-time, in-full delivery performance of 95 percent or more for even complex orders will require manufacturers to take an end-to-end view of their

Exhibit

Consumer-packaged-goods manufacturers struggle to fulfill complex orders.

Impact of order complexity on fill rate, example



Insights

- More than 70% of orders consisted of fewer than 50 line items
- Product availability at source distribution center depressed fill rate, given that large orders included both high-volume and long-tail items
- Complexity of offering can correlate with performance on retailer scorecards

forecasting, planning, manufacturing, and distribution operations. Here are four top areas of opportunity:

Significantly improve predictive precision

The combination of big data, machine learning, and advanced analytics can dramatically increase the sophistication of demand forecasts, allowing manufacturers to predict demand more accurately, at a more a granular level, and over a longer time horizon. In addition to improving inventory-allocation decisions for base SKUs, these systems can also help companies predict the impact of promotions and new-product introductions.

One large, global CPG company applied machine-learning algorithms to more than 100 specific demand drivers, including demographic and socioeconomic data on the people living near its stores, as well as local weather conditions. The approach allowed it to improve forecast accuracy by 10 to 15 percent and extend forward-looking visibility from ten days to three months.

Even the smartest forecasting technologies can only work with good data, and deliver results only if the organization acts on their information. Therefore, companies also need to ensure they have effective collaboration and data sharing with suppliers and customers. They should set an aspiration for "no touch" planning to seamlessly translate forecasts into production and deployment schedules.

Make execution flawless—and flexible

For a manufacturer's plans to survive contact with the real world, its manufacturing and warehouse operations must work efficiently and reliably. The best companies achieve these goals through a combination of new technologies and old-fashioned process discipline. They use lean methods and other performance-improvement techniques to streamline activities, cut error rates, and boost reliability. They invest in robotics and automation, especially in warehouse processes, to accelerate the handling of complex orders. And they use smart IT tools to track performance against targets in real time.

Another large consumer company built a real-time performance "cockpit" covering all critical supply-chain performance metrics across its planning, manufacturing, and logistics-execution processes. The system uses advanced algorithms to point users to exceptions that require attention, and it gives users the ability to drill down to the status of individual SKUs in specific locations on particular days. That way, users can isolate the problem and intervene immediately when necessary.

Fast, flexible manufacturing, accurate planning, and close coordination between commercial and operations functions can create a virtuous circle. Quick order-to-delivery lead times rely on more-accurate, shorter-term forecasts. And when manufacturing and logistics operations staff have forecasts they can use with confidence, they can further streamline their activities, cutting buffer stocks and other sources of waste.

Reassess supply-chain assets

Just as retailers have redesigned their logistics networks to meet higher service requirements and fulfill omnichannel orders, CPG players will have to modify their own supply-chain footprints. Fast, flexible supply chains may require distribution facilities that are located closer to critical customer facilities. The need for greater reach without excessive costs will encourage manufacturers to explore alternative ownership models: outsourcing the operation of warehouses to specialist providers, for example, or sharing facilities with customers or other players.

In this context, a global CPG manufacturer is undertaking a significant restructuring of its US distribution network. The company is consolidating distribution into fewer than a dozen primary centers and a smaller number of "mixing centers," with the goal of reducing the delivery lead time for 80 percent of its US production to less than 24 hours.

Relationships with carriers will evolve, too. To achieve greater flexibility, manufactures may need to balance relationships between companies that have their own truck fleets and brokers that can access additional capacity in the market. Carrier contracts

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> Just as retailers have redesigned their logistics networks to meet higher service requirements and fulfill omnichannel orders, consumer-packaged-goods players will have to modify their own supply-chain footprints.

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and incentive schemes will need to reflect the tight schedule compliance required to meet stringent retailer delivery windows. And the technology used to manage shipments may require an upgrade, with seamless information sharing between supplier, carrier, and retailer, and greater use of track-and-trace systems to monitor shipment progress and identify delays and problems more rapidly.

Master the complexity pipeline

Some of the complexity that impairs CPG supply-chain performance is self-inflicted. Poorly controlled new-product-introduction processes can lead to portfolio proliferation and skyrocketing numbers of SKUs to forecast, manufacture, and manage. By raising supply-chain-management costs while reducing delivery performance, new-product introductions can result in excess portfolio complexity that outweighs any profit the new products generate.

To avoid this trap, one major consumer player implemented an end-to-end complexity-reduction program. The company revisited its SKU portfolio and pipeline through the lenses of design-to-value product design, total cost of complexity by SKU, price-pack architecture, and strategic importance. The rationalized portfolio contained 20 percent fewer SKUs but allowed the company to improve sales by more than two percentage points and net margin by more than five points.

■ ■ ■

None of the opportunities described above is a quick fix. And consumer-goods companies will need to address all of them if they are to achieve significant, sustainable improvements in supply-chain performance. Companies that want to get ahead in the race for supply-chain superiority must build the systems, processes, and infrastructure today that will enable them to meet the customer expectations of tomorrow. ■

This article is adapted from "Deliver on time or pay the fine: Speed and precision as the new supply-chain drivers," which first appeared on McKinsey.com in April 2018.

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The authors wish to thank Mike Doheny, Shruti Lal, and Dan Swan for their contributions to this article.

Beyond procurement: Transforming indirect spending in retail

If retailers treat indirect costs as an opportunity for business transformation rather than just a procurement matter, they can boost return on sales by as much as 2 percent.

Steve Hoffman and Patrik Silén


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For retailers seeking to cut costs and generate cash for growth investments, indirect spending can be a big untapped opportunity. Indirect costs—the goods and services that retailers purchase but don't resell—are equivalent to 10 to 15 percent of sales on average, and most retailers know that their indirect spending is far from optimized. But while recognizing the potential is easy, capturing it has proven stubbornly difficult.

The challenges aren't new. They include a lack of spending visibility, fragmented ownership and spend authority, a dearth of incentives to reduce indirect spend, and a siloed approach to procurement of not-for-resale (NFR) categories. In addition, indirect procurement typically focuses on negotiations with suppliers over price, rather than on higher-impact opportunities to optimize what and how the retailer buys. Our research has also shown that capabilities and resourcing for NFR procurement in retail are significantly weaker than in many other sectors: NFR goods and services are viewed as much less important than goods for resale, so the NFR sourcing staff tends to receive less management attention and less investment in talent. Furthermore, even NFR sourcing professionals typically have little expertise in NFR categories. Rare is the procurement team that has deep knowledge of, say, elevator maintenance or marketing-agency overhead costs.

Visionary retailers, however, are taking a radical new approach to indirect spending—and achieving radical results. These retailers aren't viewing indirect costs as a concern only for the procurement function. Instead, they're looking to transform indirect spending across the entire business. They're overcoming the challenges by leveraging three new ways of working: a cross-functional approach that incorporates category-specific demand levers, the use of digital and analytical tools, and stronger supplier collaboration. And they're taking specific actions to bring about lasting change in mind-sets and behaviors.

In doing so, retailers are shaving as much as 10 to 15 percent off their annual indirect spend, capturing impact worth 1 to 2 percent in return on sales, and seeing a more than 15-fold return on the cost of their NFR sourcing team. We've found that the value at stake is remarkably consistent across retailers—even at those that have been working on reducing indirect costs for a long time, whether in-house or with external support.

A business transformation

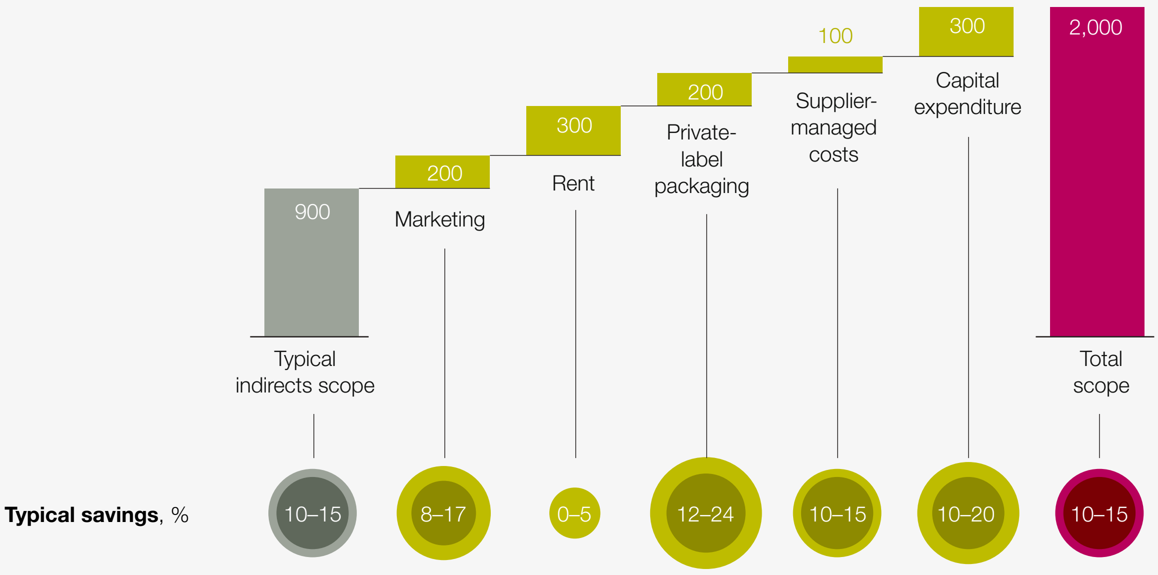
To capture maximum value from a cost-reduction program, retailers must be deliberate about the program's scope and ambition level. A broad scope and high targets are indispensable elements of a truly transformative effort.

Historically, retailers have cut costs primarily by reducing store labor or travel expenses. Few retailers have tapped into the full potential of optimizing NFR spending (Exhibit 1). Furthermore, even retailers explicitly seeking to reduce indirect spending sometimes ring-fence certain cost categories as "not addressable." For instance, some retailers consider marketing expenditures out of scope; their rationale is that marketing is critical to the core business of retail. Other retailers don't bother trying to lower rents, because they assume that they can't renegotiate terms unless they're in financial distress. Some indirect costs—such as supplier-managed logistics—remain unchallenged because they're "hidden" in cost of goods sold. And some retailers look for cost-reduction opportunities only in operating expenses, leaving all capital expenditures untouched—even though the latter often has higher savings potential (as a percentage of costs).

In bypassing these categories, retailers are forfeiting more than half of the potential impact and missing out on the synergies that a large-scale program could bring. To achieve transformative change in indirect spending, there can be no sacred cows.

Exhibit 1 **By addressing the full cost base, a retailer can double the scope and savings of its indirect-costs program.**

Typical breakdown for a €10 billion retailer, € million



Source: McKinsey analysis

Another must-do for a transformation program: set stretch targets that inspire creativity and out-of-the-box thinking. To set its NFR targets, one retailer first conducted a fact-based diagnostic that was championed by senior leaders. This exercise helped the organization understand that the program was a priority, adopt a transformational rather than an incremental mind-set, and focus on how to achieve the targets rather than on trying to change them.

New ways of working

Seeing an NFR effort as a business transformation is a crucial first step. To maximize NFR savings, retailers then need to adopt three new ways of working.

A cross-functional approach incorporating category-specific demand levers

Transformation of indirect spend will require the involvement and commitment of more than just the procurement staff. A cross-functional team can break down silos, pose tough questions about what the business really needs, and make balanced trade-offs.

A cross-functional team can pull the basic supplier-management levers (such as competitive bids and supplier consolidation) that affect *who* the retailer buys from and *at what price*. The team can also pull process-management levers, which influence *how* a retailer buys: if the various functions comply with procurement policies and use only preferred vendors, maverick spending will be reduced or even eliminated. Savings across the organization can be more easily tracked. The retailer can better negotiate vendor payment terms and cycles to its benefit.

Most important, a cross-functional team will be better placed to pull category-specific demand-management levers, which influence *what* the retailer buys. In our experience, these levers deliver as much as half of the potential savings—or even more for mature companies, because negotiating for lower prices yields diminishing returns over time. The biggest opportunities are often in areas that many retailers consider out of scope, such as marketing (by using a return-on-investment approach, for instance) or logistics (using levers such as inventory reduction or network redesign).

A retailer seeking to optimize logistics spending tasked a cross-functional team with redesigning its distribution network. The team was able to reduce end-to-end costs by selectively increasing certain logistics costs. For example, it switched some deliveries from sea to air in order to gain sales and reduce markdowns. It also increased delivery frequency for some products and stores while decreasing it for others.

The use of digital and analytical tools

Digitization has revolutionized every business process and will continue to do so; indirect sourcing is no exception.[1] Today, leading retailers are using digital and analytical tools in the following areas to achieve dramatic reductions in indirect costs:

- *Spend visibility.* Advanced digital solutions, powered by artificial intelligence (AI) and machine learning, enable retailers to rapidly and accurately map the relevant spend base into granular categories, shedding light on exactly who spends how much on what. Cutting-edge digital procurement solutions can pull purchase-order (PO) and invoice data from multiple systems to create a "spend cube," automatically generating benchmarks on pricing and specs, as well as dashboards and reports to help category managers monitor spending. One retailer had recently streamlined its headquarters organization but found through AI-supported spend mapping that many of the costs had crept back in through the use of contractors and temporary labor. Once the retailer generated the spend cube using an agreed taxonomy, it could lock down a baseline and see how much it was spending on contracted versus uncontracted vendors.

- *Consumer insights.* A retailer used digital consumer surveys and crowdsourced competitor benchmarks to understand, address, and retest consumer perceptions of store cleanliness. Which areas of the store did consumers notice most? Which areas did they hardly notice at all? Analysis showed that the parking lot and the sidewalks were perceived as clean enough, so instead of hiring a cleaner to do a thorough cleaning multiple times a day, the retailer cut back to once a day, with store associates doing spot checks every few hours. The surveys also revealed places—such as fitting rooms and the shoe department—where the retailer could invest in more frequent cleaning to boost customer satisfaction. The business-insights team then measured the exact impact of these adjustments on the retailer's sales.

- *Design to value.* A retailer reduced the cost of its paper shopping bags by 25 percent by redesigning them. Through digital analysis of basket size, product dimensions, and data from cashier surveys, the retailer determined the ideal dimensions of a shopping bag based on the distribution of physical volume and weight of products. Further digital analysis—along with input from cashiers, baggers, and vendors—helped the retailer arrive at the substrate composition that would give the shopping bags the right levels of puncture strength and tensile strength.

- *Clean sheeting.* Digital clean-sheeting tools can reduce indirect costs by as much as 40 percent in a category. Such tools typically feature algorithms for determining costs in various NFR areas, dynamic databases of input costs (such as raw-material index prices), and a sophisticated calculation engine. Through a clean-sheeting exercise, one retailer discovered that it was paying much more than the "should cost" for water-bottle labels (Exhibit 2).

- *Spend control.* Digital procure-to-pay tools give retailers better spend control by enforcing more discipline in how suppliers are set up and approved, and by supporting a more rigorous PO-approval process.

- *Zero-based budgeting (ZBB).* Using digital tools (and enabled by increased spend visibility), retailers can easily build detailed bottom-up budgets, detect the exact drivers of variances, and take swift action to close gaps. ZBB, which first gained traction in consumer-goods companies, can be powerful for retailers, especially in store-related NFR categories. Determining the appropriate budget for each store and then tracking adherence to that budget can yield significant savings.

Closer collaboration with suppliers

Retailers should work with suppliers on cost improvements and innovations. Suppliers can be great idea generators because they know a retailer's bad habits better than the retailer itself does and would rather help change those habits than lose the business. Retailers can also invest in improving supplier capabilities in ways that will pay the

Exhibit 2

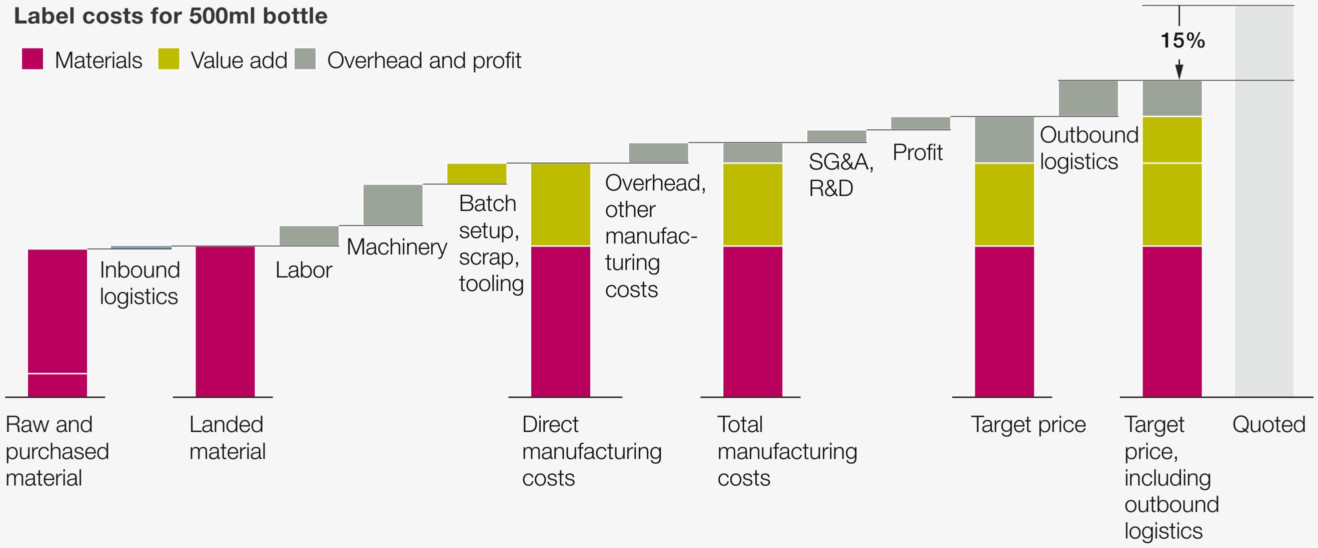
Through clean sheeting, a retailer saw that it was paying more than the 'should cost' for labels on its water bottles.

Key assumptions

Profit of 5% included in price
Batch size of 2 million pieces (est.)
Yearly volume of 6 million pieces (est.)
Manufacturing location: Eastern Europe

Interest rate of 3%
Selling, general, and administrative (SG&A) costs of 5%
Range of labor rates in local currency depending on skill level
Selling tax and value-added tax not included

Label costs for 500ml bottle



Source: McKinsey analysis

investment back several times over. Among the benefits of stronger supplier relationships: better product quality and availability, faster responses to market needs, less administrative effort, greater efficiency, and lower total cost.

The elements of successful supplier collaboration include focusing on a limited number of suppliers to deliver the highest return on investment, establishing a robust value-sharing agreement at the outset, creating a dedicated supplier-collaboration team separate from but aligned with category managers, and building a disciplined performance-management and benefits-tracking system.

One retailer, when retendering its contracts for outsourced warehousing, required suppliers to submit proposals for improving the joint warehousing operation. Based partly on these proposals, the retailer reduced its supplier count to two, allowing for closer collaboration while maintaining some competitive tension. The retailer built continuous-improvement targets into the contracts, with gainsharing incentives for the suppliers. It also invested in a "lean warehousing" team that works closely with the suppliers to build capabilities.

Getting it done

Retailers must embed these new ways of working into daily tasks. To sustain behavioral change, they must then use all four parts of the "influence model" (Exhibit 3).[2]

Fostering understanding and conviction

Leading retailers lay out a clear **case for change** and help each stakeholder connect to it on a personal level. An important aspect of the change story is communicating why savings are needed and what they will be used for. Allowing business units or functions to reinvest part of the savings can increase motivation. (One initiative leader at a retailer put it this way: "Half goes to the CFO, but the other half we get to keep.") The head office should, of course, have enough visibility into the reinvestments to ensure they align with corporate priorities and generate strong returns.

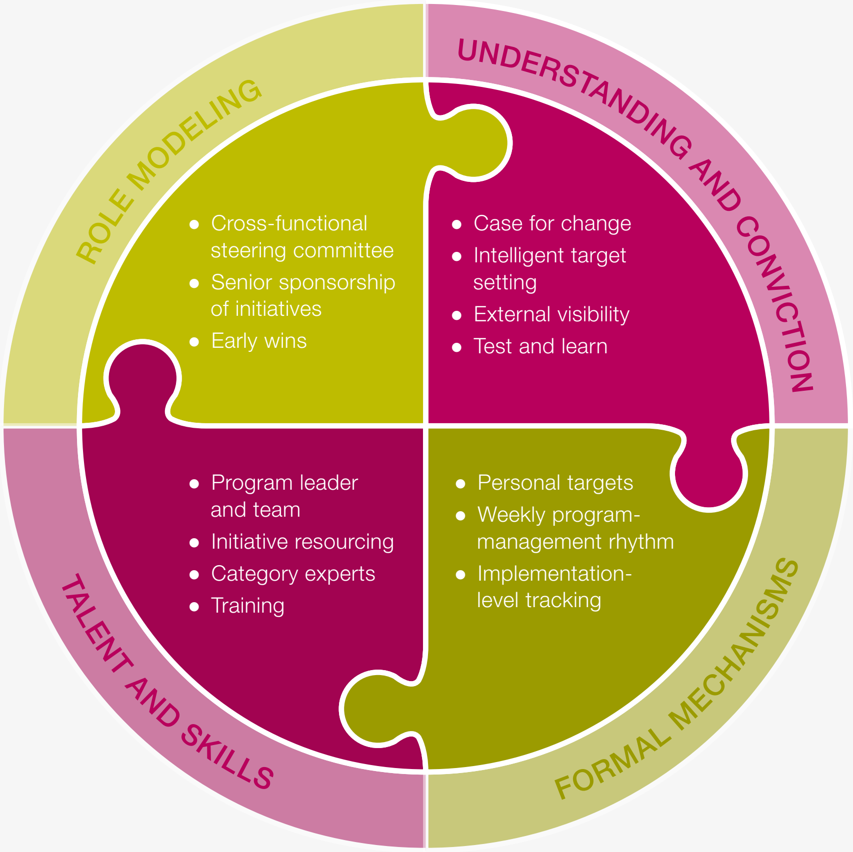
Intelligent target setting also helps foster understanding across the organization. Targets should be based on detailed diagnostics, including benchmarking against a relevant peer set. Otherwise, stakeholders will reject the targets as arbitrary; there's also a risk of damaging the business by pushing it into "slash and burn" cost cutting. The diagnostics should yield not just a single target—say, $100 million in cost savings—but also a set of quantified initiatives. Targets should include cost ratios (for example, logistics spending as a percent of sales) rather than just absolute numbers, to ensure that cost efficiency genuinely improves even when the category experiences tailwinds. (For example, a decline in logistics costs due to a decline in sales isn't really an improvement.)

Because indirect sourcing is typically perceived as a backwater and procurement staff can feel they're performing thankless work, **external visibility** can be highly motivating. When retail CEOs publicize their NFR initiatives and targets, the people involved in the initiatives see that their work matters and even has the power to influence their company's stock price.

Along the NFR journey, there will be times when stakeholders resist change for fear of negatively affecting sales. A **test-and-learn** culture can overcome this. A first step can be to show mock-ups or samples of proposed changes. One retailer's procurement team recommended using thinner, cheaper paper for marketing materials. It overcame resistance from the marketing department by having samples printed on the thinner paper and using blind testing to demonstrate that the materials were just as effective.

Exhibit 3 Retailers can use a range of tactics to change mind-sets and behaviors.

The influence model's four building blocks of change



Reinforcing with formal mechanisms

Company goals should be translated into **personal targets.** One retailer created a simple timeline of when initiatives were expected to deliver impact, using the top end of the impact range estimated for each initiative. The resulting quarterly figures became targets for the relevant executives, whose bonuses were partly dependent on hitting those targets.

To follow up on progress against targets, many retailers instinctively go for a monthly cadence of follow-up meetings. But, in our experience, a **weekly program-management rhythm** is much more effective for driving the pace of initiatives and bringing about cultural change. During the weekly meeting, the team reviews all initiatives but focuses on only a few, either on a rotating basis or to help those that need additional support.

Initiatives should be tracked not only against milestones but also on progression through "implementation levels": an initiative begins as an idea, matures to a business case, becomes an approved decision, gets implemented, and is ultimately converted to "money in the bank." The expected impact of initiatives can be appropriately "discounted" when they are in earlier stages. **Implementation-level tracking** gives the program leader and steering committee a more accurate picture of when impact will be delivered and which initiatives need what kind of support. Linking this tracking to ongoing budgeting, forecasting, and performance-management processes yields greater transparency in profit-and-loss performance.

Developing talent and skills

An NFR program needs a capable **program leader and a supporting team.** The program leader, who will likely come from a line role, should know the business well and have the respect of top management. Given this individual's talent and leadership skills, it won't be an easy decision for senior executives to free him or her up to lead the program. But the sacrifice will pay off.

Still, without sufficient **resources for each initiative,** the program will struggle. Colleagues from each function or cost category will need to dedicate 10 to 20 percent of their time to the effort. For one $10 billion retailer, delivering $200 million in savings required a program leader and about 40 full-time equivalents (FTEs) working for 12 months. Company leadership had to stop or pause other initiatives to create the required capacity. While 40 FTEs might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sound like an enormous investment, the retailer recouped the cost of those employees' yearlong efforts about 50 times over in recurring savings.

Neither the program leader nor the team members can be expected to have all the relevant category-specific expertise. Our research shows that retailers have eight times the indirect spend per procurement professional compared with other sectors, which means their level of expertise in any particular category will be relatively shallow. Therefore, tapping into internal and external **category experts** is crucial. One grocery retailer discovered that one of its project managers had been a refrigeration engineer for 25 years. The company brought him into a team tasked with reducing the life-cycle cost of refrigeration, heating, and cooling assets by 30 percent in two years. The team achieved the goal in six months and did so with simple solutions—for example, changing the type of price tags used in refrigerated shelves so that the tags wouldn't fall off and clog the drain. This change saved the retailer more than $600,000 a year.

Capability building is also key. The best companies use a combination of classroom training, e-learning tools, and on-the-job coaching. In our experience, many NFR professionals who receive **functional and category-specific training** and mentoring immediately double or triple their effectiveness. A phased train-the-trainer approach—in which the sourcing team receives training during a pilot phase, applies the learnings to an initial set of categories, then trains others in the next phase—has proven effective in many cases.

Role modeling

The CEO, CFO, and the rest of the management team must work together to communicate the case for change and role model the desired mind-sets and behaviors. Working as a **cross-functional steering committee,** they can remove roadblocks, surface and capture cross-functional opportunities, and allocate enough resources to them, thereby sending an unmistakable message to the organization about the importance of these initiatives.

Another powerful role-modeling lever is **senior sponsorship of initiatives.** Senior leaders can serve as coaches for the owners of individual category initiatives, whether those owners are within or outside the senior leaders' respective functions.

Helping to secure—and then celebrate—**early wins** is also a form of role modeling. It lets the entire

Our research shows that retailers have eight times the indirect spend per procurement professional compared with other sectors, which means their level of expertise in any particular category will be relatively shallow.

organization see that senior leaders are committed to ensuring the NFR program's success and that they recognize its impact.

■ ■ ■

Most retailers have significant opportunities to reduce indirect costs. The first step is to acknowledge that the potential exists, then conduct a thorough diagnostic to quantify it. Though challenging, a transformation in indirect spending can yield greater profitability, funding for growth, and competitive advantage. ■

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[1] For more on digital solutions in procurement, see Pierre de la Boulaye, Pieter Riedstra, and Peter Spiller, "Driving superior value through digital procurement," April 2017, McKinsey.com.

[2] For more on the influence model, see Tessa Basford and Bill Schaninger, "The four building blocks of change," *McKinsey Quarterly*, April 2016, McKinsey.com.

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Are your fruits and vegetables top-notch?

Daniel Läubli and Nora Ottink

When shopping for fresh produce in the summertime, European consumers pay close attention to the quality of apples, bananas, tomatoes, and lettuce (exhibit). These insights were among those generated in our first-of-its-kind benchmarking survey of more than 23,000 grocery shoppers in four European countries.

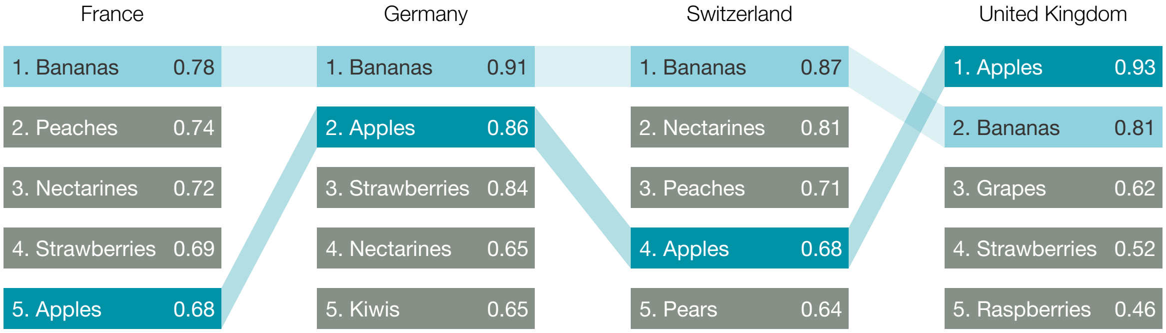
Our research demonstrates that quality is *the* biggest factor in whether a customer will recommend a store's fresh-produce department to other people. Low prices and frequent promotions matter, too, but not as much as quality. Furthermore, quality perception is influenced by only a handful of products—usually fewer than ten. If a retailer improves the quality of just these few products in its stores, it will move the needle on customer satisfaction significantly. We call these products "key quality items" (KQIs).

Retailers should prioritize KQIs for quality investments. As the exhibit shows, the KQIs in the fresh-produce department differ by country and by season.

Exhibit

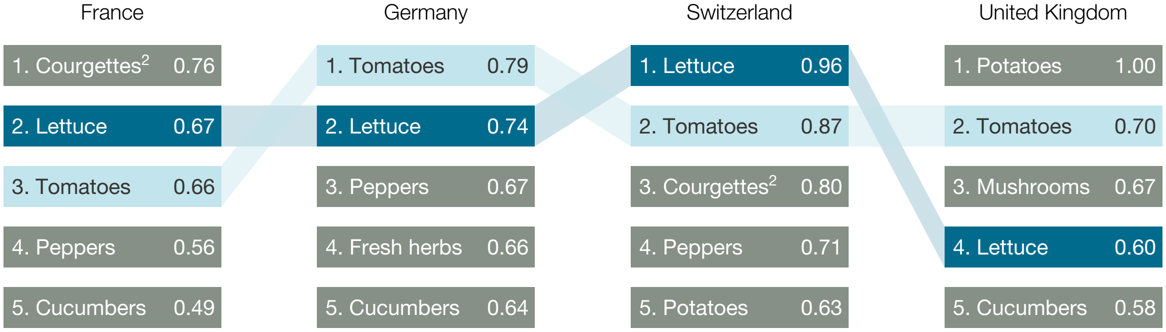
‘Key quality items’ differ across countries.

Top 5 fruits by importance of quality for retailer in the summer season[1]



France	Germany	Switzerland	United Kingdom
1. Bananas 0.78	1. Bananas 0.91	1. Bananas 0.87	1. Apples 0.93
2. Peaches 0.74	2. Apples 0.86	2. Nectarines 0.81	2. Bananas 0.81
3. Nectarines 0.72	3. Strawberries 0.84	3. Peaches 0.71	3. Grapes 0.62
4. Strawberries 0.69	4. Nectarines 0.65	4. Apples 0.68	4. Strawberries 0.52
5. Apples 0.68	5. Kiwis 0.65	5. Pears 0.64	5. Raspberries 0.46

Top 5 vegetables by importance of quality for retailer in the summer season[1]



France	Germany	Switzerland	United Kingdom
1. Courgettes[2] 0.76	1. Tomatoes 0.79	1. Lettuce 0.96	1. Potatoes 1.00
2. Lettuce 0.67	2. Lettuce 0.74	2. Tomatoes 0.87	2. Tomatoes 0.70
3. Tomatoes 0.66	3. Peppers 0.67	3. Courgettes[2] 0.80	3. Mushrooms 0.67
4. Peppers 0.56	4. Fresh herbs 0.66	4. Peppers 0.71	4. Lettuce 0.60
5. Cucumbers 0.49	5. Cucumbers 0.64	5. Potatoes 0.63	5. Cucumbers 0.58

[1] Average of the normalized correlation of the perceived product quality with the perceived quality of fruit-and-vegetable department, with a normalized share of customers buying the product.

[2] Zucchini.

Source: McKinsey's European Retail Benchmark on Fresh Quality, July 2017

To learn more, read “In fresh-food retailing, quality matters more than price,” on McKinsey.com.

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