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Consumer Goods and Retail

Navigating a perfect storm in the Middle East's consumer sector

Amid major shifts in the consumer and business landscape, companies in the Middle East must revamp their value propositions and relentlessly push for productivity—while investing in digital, analytics, and M&A capabilities.

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Consumers in the Middle East are changing their buying behavior. They're feeling less optimistic about their financial prospects and are therefore spending less. They're also becoming less brand loyal and more demanding—expecting more convenience, more health-oriented options, and locally sourced products.

These shifts in consumer expectations and behavior, which were evident in the results of our latest Middle East Consumer Sentiment Survey (more on that below), are among several challenges that retailers and consumer-packaged-goods (CPG) manufacturers in the region have been facing. Another is the influx of competitors: retailers are competing with fast-growing online players, while large CPG manufacturers are losing share to smaller brands. Furthermore, structural changes—such as volatility in oil prices and geopolitical developments—are subjecting companies to higher costs and bigger risks.

The confluence of these trends has formed a perfect storm for retail and CPG companies. It's the Middle East's new normal, as we described in a November 2017 article,[1] and it's becoming "stickier"; the trends show no signs of ebbing. What will it take for retailers and CPG manufacturers to succeed in this environment? We believe what's required is the development of a new consumer value proposition and a relentless productivity push to finance new investments. And these undertakings won't be possible without robust capabilities in digital, analytics, and M&A.

The Middle Eastern consumer today

In each of the past three years, we've conducted an online survey among more than 2,000 consumers in two of the region's largest economies, the Kingdom of Saudi Arabia (KSA) and the United Arab Emirates (UAE).[2] We've asked respondents about changes in their financial sentiment and buying behavior.

Our latest survey, conducted in September 2018, revealed the following shifts in consumer behavior:

Price sensitivity is growing steadily. Consumers in the Middle East are spending even more cautiously than they have in previous years. They're also more anxious: 80 percent of survey respondents in the UAE (up from 75 percent three years ago) and 72 percent in the KSA (up from 62 percent three years ago) are worried about losing their jobs. In both countries, more than 40 percent of respondents said they're cutting down on spending and paying closer attention to prices.

Brand loyalty is eroding. Today's Middle Eastern consumers tend to be less brand loyal. More of them are switching from their preferred brands to less-expensive options. In both the KSA and the UAE, at least 15 percent of consumers reported trading down (Exhibit 1), whereas trade-down rates three years ago were only about 10 percent. Among down-traders, the majority opted to buy lower-priced branded goods. More than half of down-traders don't intend to trade back up even after their financial situation improves.

E-commerce is catching on. Even as they're spending less, consumers in the region are expecting more from retailers and CPG manufacturers. For instance, they expect to be able to buy products quickly and conveniently. Speed and convenience are the main reasons that Middle Eastern consumers have grown increasingly comfortable with e-commerce. In the UAE, survey respondents estimated that they've increased their online spending by 31 percent over the past year, and 62 percent of respondents cited convenience as the top factor for shifting to the online channel.

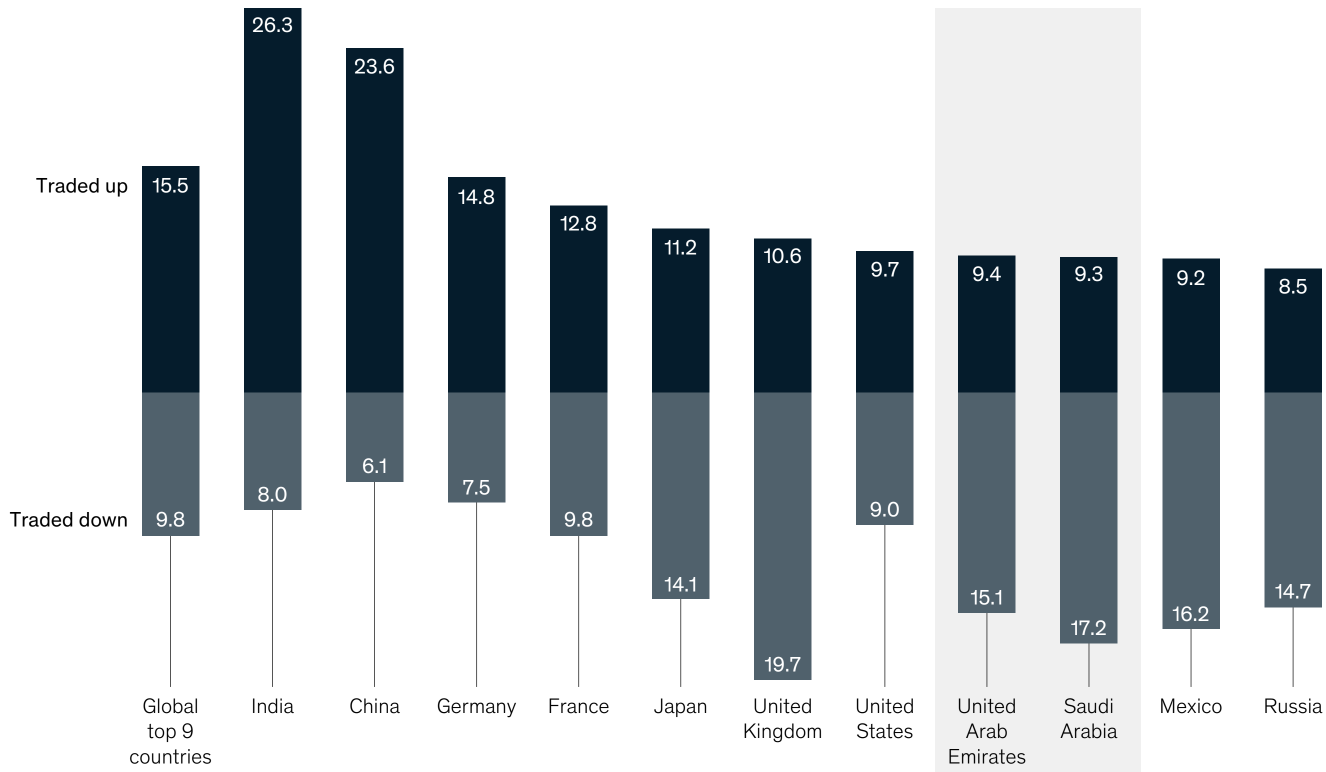
Health and wellness are becoming more important. Another area in which consumers have higher expectations is access to products with health and wellness benefits. In the UAE, for

[1] Peter Breuer, Gemma D'Auria, Abdellah Iftahy, and Tarek Mansour, "Retailing in the Middle East: How to recapture profitable growth," *Perspectives on retail and consumer goods*, November 2017, McKinsey.com.
[2] The Middle East survey is part of the McKinsey Global Consumer Sentiment Survey. The latest global survey, conducted in September 2018, garnered responses from 17,700 consumers in 15 countries.

Exhibit 1

In the Middle East, more consumers reported trading down than trading up.

Stated behavioral shifts in the past year,[1] 2018, %



[1] Among those who changed buying behavior. Weighted average for categories.
Source: McKinsey 2019 Global Sentiment Survey

example, more than 50 percent of consumers in every age group (baby boomers, millennials, and Gen Xers)—compared with only 33 percent of US consumers—said that having “all-natural ingredients” is either “always” or “usually” an important consideration for them when buying packaged foods. More than 40 percent of UAE respondents said that “low sugar,” “low fat,” and “made with real sugar, not substitutes” are important considerations as well (Exhibit 2).

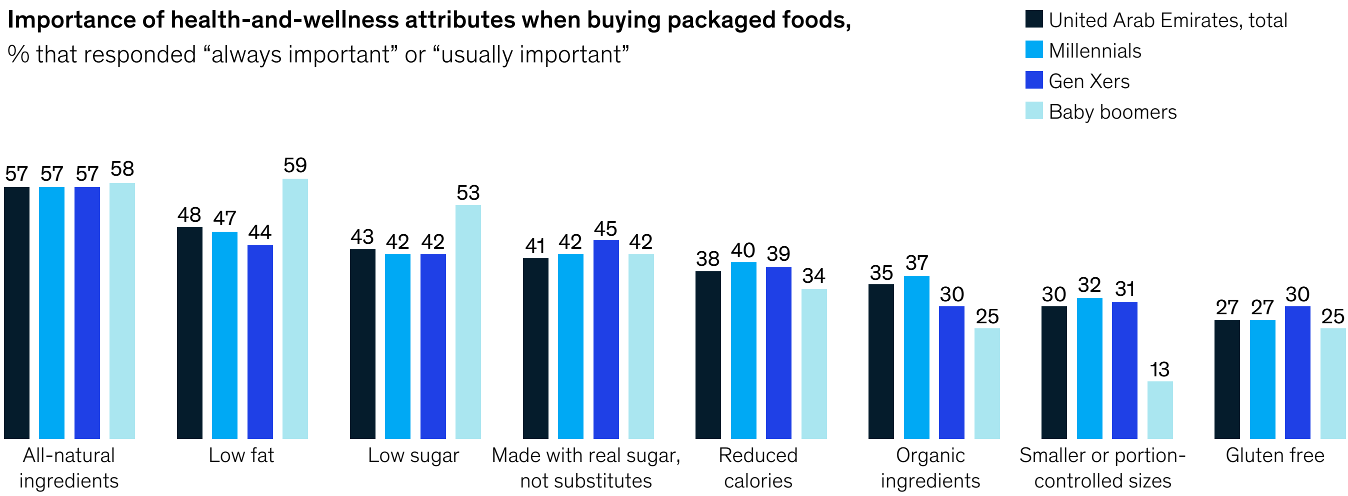
Demand for local goods is growing. Supporting local businesses by buying locally sourced products is yet another emerging trend, especially among younger generations. A recent McKinsey survey of millennials showed that they are almost four times more likely to distrust “big food companies.” A modern retailer therefore must play the role of not only a provider of products but also a business platform for local brands to gain exposure and grow. In the Gulf Cooperation Council (GCC) countries, the trend is evident in the rapid growth of several local brands in apparel, cosmetics, and food.

Few incumbent companies have amply responded to these shifts. As a consequence, for most retailers and CPG manufacturers in the region, revenue growth has stalled or even fallen: in the past year, luxury retailers’ sales declined by 3 percent on average, while large grocers’ sales declined by 3 to 8 percent.

Exhibit 2

More than 50 percent of United Arab Emirates survey respondents value ‘all-natural ingredients’ when buying packaged food.

Importance of health-and-wellness attributes when buying packaged foods,
% that responded “always important” or “usually important”



Source: McKinsey 2019 Global Sentiment Survey

More competitors, higher costs

Yet this tough business environment hasn’t discouraged new entrants. Assertive start-ups have entered the fray and are growing fast. Online players—including Souq by Amazon, Awok, Jollychic, Noon, and Rocket Internet spin-offs Namshi and Wadi—are luring Middle Eastern consumers away from physical stores. Online penetration is at only 2.5 percent across the Middle East today but is expected to more than double by 2022. Online retail sales are projected to grow by 20 percent or more per year between 2017 and 2022, far outpacing the estimated 3 to 5 percent compound annual growth rate for brick-and-mortar sales. All told, the number of retail competitors is rising even as the retail profit pool is shrinking.

At the same time, the costs of doing business keep inching up. In 2018, companies in the Middle East were affected by new value-added taxes, reductions in utility subsidies, and rising expatriate visa fees.

We expect these trends to have staying power. That means companies won’t survive unless they undertake a strategic refocus—and quickly. Those that take a wait-and-see stance will get left far behind by more agile, fast-moving competitors.

Building blocks of a winning strategy

Against this backdrop, retailers and consumer-goods companies will need to adopt a new strategy that consists of two core building blocks: a new and distinctive consumer value proposition and a relentless productivity push. These building blocks must then be enabled and enhanced by new capabilities in digital, analytics, and M&A.

A distinctive value proposition

In light of changing consumer expectations and preferences in the Middle East, it’s no longer enough for companies to stack a wide assortment of products on store shelves in the hopes that this

Companies must fine-tune their assortment, branding, and pricing and promotions to meet the specific needs of the increasingly price-sensitive and more demanding consumer.

broad-based approach will attract all consumers. Retailers and CPG manufacturers must move away from traditional macro-segmentation and instead tailor all elements of their marketing strategy toward clearly defined micro-segments—and, eventually segments of one.

Companies must fine-tune their assortment, branding, and pricing and promotions to meet the specific needs of the increasingly price-sensitive and more demanding consumer. They might, for instance, offer healthier products and local goods, but at entry-level prices. They might choose to compete in the low-end market by launching private-label “fighter brands” or by introducing new, affordable pack sizes. In addition, companies must ensure a convenient omnichannel shopping experience. This means retailers should consider ramping up their e-commerce presence, while CPG manufacturers must improve route-to-market execution and forge strong relationships with reliable distribution partners, both offline and online.

Generating deep consumer insights is critical in the new normal. Personalization, in particular, will yield outsize benefits. In a recent McKinsey survey, approximately 80 percent of consumers said they’d like to receive personalized offers. Although personalization has become a top strategic priority for most retailers, few retailers feel they’re doing a good job at it.

Leading retailers around the world have deployed advanced analytics and machine learning to generate personalized product recommendations on their websites, with significant returns on investment. Beauty-products retailer Sephora, for instance, makes recommendations to website visitors based on several different strategies (such as “similar items” or “often bought together”), selecting the strategy that works best in each market. Sephora has seen more than $6.50 in revenue for every dollar spent on personalization.

A relentless productivity push

Developing a compelling value proposition will require investment. However, with Middle Eastern consumers constantly on the lookout for savings, companies won’t be able to raise the necessary funding through price increases. Companies will need to find ways to keep prices low and extract enough value from their current business to finance new initiatives without compromising margins or the customer experience.

Smart companies will fundamentally rethink their cost structure—taking an end-to-end view of the business and exploring opportunities in all cost areas including shrinkage (where typical savings is 30 to 45 percent of baseline), store operations (5 to 10 percent of baseline), indirect spending (10 to 15 percent), and supply chain (5 to 10 percent). They might also consider adopting a zero-based budgeting approach.

One leading grocer reduced shrinkage by 33 percent in its fruits-and-vegetables department by revamping its replenishment and store-ordering processes and tools. Another large retailer significantly reduced supply-chain costs through lean warehousing (5 percent savings through reduced overtime and optimized slotting), network optimization (10 percent savings through analytics-driven demand allocation and dynamic truck routing), and transportation (5 percent savings through renegotiated rates and improved fleet management).

Enablers: Analytics and M&A

Coming up with a new value proposition and successfully executing a productivity push aren't simple, one-time tasks. They require a culture of innovation and continuous improvement.[3] In addition, companies need a set of enablers—namely, cutting-edge digital and analytics capabilities and M&A skills—to support and sustain their new strategy.

Digital and analytical capabilities

Digital and analytics skills are already benefiting retailers across a wide range of use cases including, as mentioned, personalization and supply chain (Exhibit 3). Depending on the use case, companies have seen uplifts of between 2 and 10 percent in

Exhibit 3

Use cases for digital and analytics capabilities span the entire retail value chain.

Apparel, example use cases

Sales and merchandising
— Insights-based selling
— Pricing optimization and architecture
— Assortment, space, and display tailoring
— Store clustering and localization
— Customer-insight-led design to value
— Promotion and clearance optimization

Digital and omnichannel
— Omnichannel category management
— User-experience personalization and optimization
— Dynamic pricing
— Digital customer care
— Retail footprint

Marketing and personalization
— Customer life-cycle management and customer acquisition
— Differentiated loyalty programs
— Marketing return on investment and media mix
— "Consumer back" innovation
— Social listening to inform marketing

Operations and supply chain
— Demand forecasting, inventory planning, and allocation
— End-to-end supply-chain planning and out-of-stock prevention
— Network optimization and dynamic routing
— In-store execution excellence and staffing
— In-store selling

People analytics
— High-performance retention
— Diversity and inclusion
— Organizational health
— HR analytics for improved frontline performance

[3] Marc de Jong, Nathan Marston, and Erik Roth, "The eight essentials of innovation," *McKinsey Quarterly*, April 2015; and Andy Eichfeld, David Golding, David Hamilton, and Kathy Robinson, "Continuous improvement—make good management every leader's daily habit," July 2017, McKinsey.com.

sales and two and three percentage points in profit. Apparel players, for instance, have been able to increase marketing-spend effectiveness by as much as 25 percent and reduce inventory costs by 10 to 15 percent through advanced analytics.

As companies in the Middle East seek to tailor their consumer value proposition to their target customer segments, assortment optimization will become an increasingly important use case for digitization and analytics. For many retailers today, assortment optimization remains just an exercise in "cutting the tail," or de-listing the lowest-volume SKUs. But some low-volume SKUs are highly important to certain customers. A retailer that de-lists those SKUs risks losing customers—they may choose to shop for that category elsewhere or, worse, they may stop coming to that store entirely.

Instead, retailers should measure shoppers' varying degrees of loyalty to each SKU in a category: Which SKUs are essentially interchangeable, and which ones play a unique role in the assortment? By conducting big data analytics and proprietary simulations on anonymized transaction data at the household or individual level, a retailer can predict customers' switching behavior. For example, if a particular SKU were to be de-listed, analytics could predict how much volume would be lost to another SKU in the same brand, lost to another brand, or lost entirely because the consumer decides to walk out of the store without buying anything—a metric we call "walk rate" (Exhibit 4).

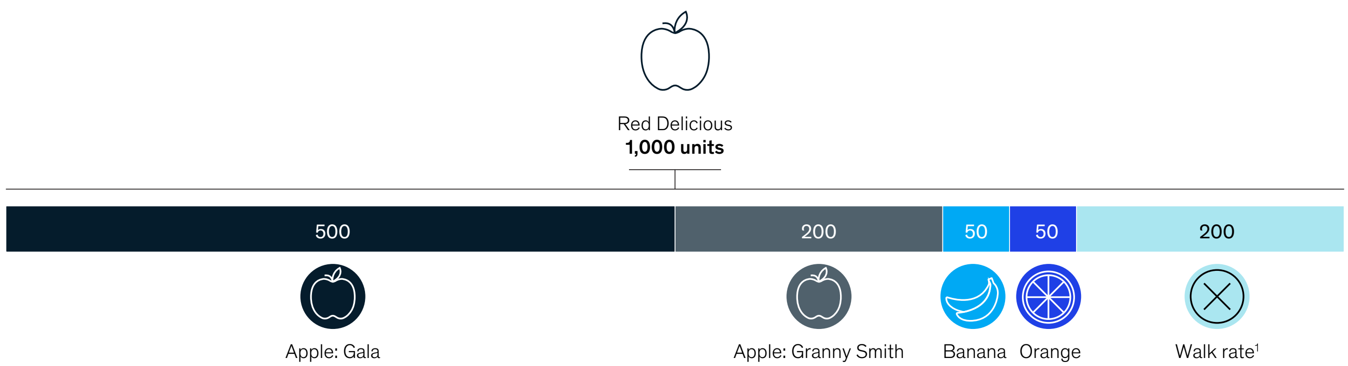
The use of advanced analytics in assortment optimization enables retailers to take a data-driven approach, rather than relying exclusively on the instincts and experience of store managers. The impact is typically a 2 to 4 percent sales increase.

Leveraging digital and analytics capabilities is fast becoming table stakes—yet, many companies see

Exhibit 4

When making assortment decisions, a retailer can use advanced analytics to predict the effects of de-listing a SKU.

Volume transfer when red delicious apples are not available, units



[1] Volume lost entirely, because shopper walks out of store without buying a substitute product.

[4] Helen Mayhew, Tamim Saleh, and Simon Williams, "Making data analytics work for you—instead of the other way around," *McKinsey Quarterly*, October 2016; and Peter Bisson, Bryce Hall, Brian McCarthy, and Khaled Rifai, "Breaking away: The secrets to scaling analytics," May 2018, McKinsey.com.

their digital initiatives fail. The success factors for using and scaling these capabilities include aligning on strategy; building solid foundations of data, technologies, and people; and embedding data and analytics into decision-making processes.[4] Talent and culture are especially important—in particular, building a multiskilled team that includes not just data scientists and data engineers but also designers and "translators," ensuring the commitment of company leadership, and providing incentives for the use of digital technologies and analytics in daily work.

M&A capabilities

To drive productivity, companies need to achieve a certain scale. Consolidation in the Middle Eastern consumer sector is inevitable as companies seek to increase their purchasing power and capture cost savings. In the past two years, for example, Majid Al Futtaim acquired Géant's franchise operations in UAE, Kuwait, and Bahrain in 2017. In the online space, Amazon took over Souq.com, Jollychic took over the MarkaVIP brand, and Emaar acquired Namshi. In the CPG sector, leading KSA dairy player Nadec announced its intention to merge with Al Safi Danone, another top five player. We believe M&A activity in the Middle East's consumer sector will only accelerate as the gap between strong and challenged players widens.

Strong companies should ensure that they're financially prepared to pounce on an M&A opportunity when it arises—specifically, by reducing debt and freeing up cash. In addition, they should evaluate their portfolios more than once a year, close deals quickly, and build robust integration capabilities.

Understandably, companies in the Middle East are still adjusting to the new normal. It's no easy task. But by staying abreast of changing consumer trends, freeing up funds through a focus on productivity, and building new capabilities in digital, analytics, and M&A, retailers and CPG manufacturers can deliver what consumers want—regardless of what direction consumer sentiment takes in the coming years.

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