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Consumer Packaged Goods

The new model for consumer goods

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Why the industry's historic value-creation model is faltering—and how to reinvent it.

The fast-moving-consumer-goods industry has a long history of generating reliable growth through mass brands. 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, FMCGs need to reduce their reliance on mass brands and offline mass channels and embrace an agile operating model focused on brand relevance rather than synergies.

A winning model for creating value

For many decades, the FMCG industry has enjoyed undeniable success. By 2010, the industry had created 23 of the world's top 100 brands and had grown total return to shareholders (TRS) almost 15 percent a year for 45 years—performance second only to the materials industry.

The FMCG value-creation model

This success owed much to a widely used 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. This capability achieved reliable growth and gross margins that are typically 25 percent above 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 their partners grew. Small competitors lacked such access.

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

- Designed their operating models for consistent execution and cost reduction. Most have increased centralization in order 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 post acquisition. After updating their portfolios with new brands and categories, these companies applied their superior distribution and business practices to grow those brands and categories.

Signs of stagnating success

But this long-successful model of value creation has lost considerable steam. Performance, especially top-line growth, is slipping in most subsegments. The household-products area, for example, has dropped from the sixth most profit-generating industry 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' growth in TRS lagged the S&P 500 by three percentage points from 2012 to 2017. As recently as 2001–08, their TRS growth beat the S&P by 6 percent a year.

The issue is 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, a figure that is a bit lower than global GDP over the period. But companies with net revenue of more than $8 billion grew at only 1.5 percent (55 percent of GDP), while companies under $2 billion grew at twice the large company rate.

This difference suggests that large companies face a serious growth penalty, which they are not making up for through their minor expansion in earnings before interest and taxes (Exhibit 1).

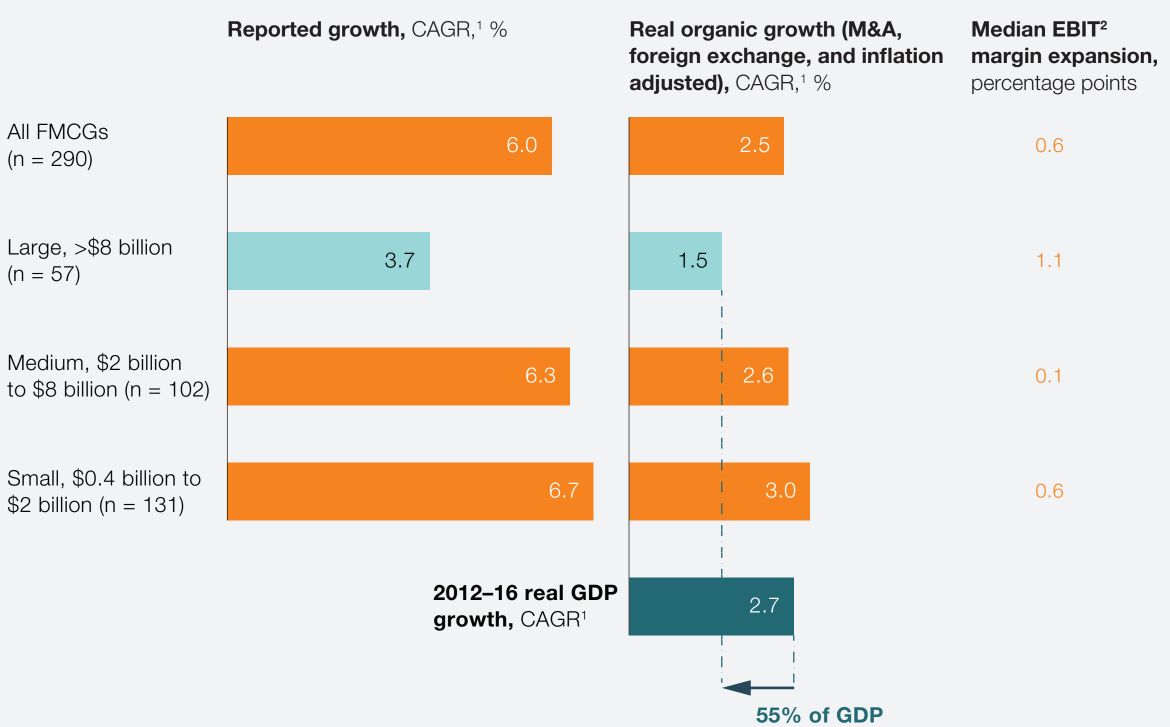
This growth challenge really matters because of the particular importance of organic growth in the consumer-goods industry. FMCG companies that achieve above-market revenue growth and margin expansion generate 1.6 times as much TRS growth as players who only outperform on margin.

Ten disruptive trends that the industry cannot ignore

Why has this FMCG model of value creation stopped generating growth? Because ten technology-driven trends have disrupted the marketplace so much that the model is out of touch. Most of these trends are in their infancy but will have significant impact on the model within the next five years (Exhibit 2).

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 FMCGs larger than $400 million in net revenue



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

Source: The World Bank Group; McKinsey analysis

Exhibit 2 **Ten trends are disrupting the historic value-creation model in the fast-moving-consumer-goods (FMCG) industry.**

FMCG industry's 5-part model for value creation

Moderate 1 2 3 4 5 Very high

	Value created	10 disruptive trends	Trend impact: Past 5 years	Trend impact: 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 2 2 3	4 5 4 5
2 **Advantaged consumer access via mass-trade relationships**	• Broad distribution • Limited competitive set	• E-commerce giants • Discounters • Mass-merchant squeeze	2 3 2	5 4 5
3 **Developing market-category creation alongside rising incomes**	• 75% of FMCG revenue growth over past 10 years	• Rise of local competitors	2	3
4 **Operating model that drives consistent execution and achieves cost reduction**	• ~4–6% general and administrative	• Pressure for profit from activist investors	2	4
5 **M&A to consolidate markets and enable organic growth post acquisition**	• Attractive market structure • Opportunity to step change organic revenue growth	• Building competition for deals	2	2

[1] Internet of Things.

Disruption of mass-market product innovation and brand building

Four of the ten trends threaten the most important element of the current model—mass-market product innovation and brand building.

The millennial effect

Consumers under 35 differ fundamentally from older generations in ways that make mass brands and channels ill suited to them. They tend to prefer new brands, especially in food products. According to recent McKinsey research, 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 research, they resist brand-owned marketing and look instead to learn about brands from each other. They also tend to believe that newer brands are better or more innovative, and they prefer not to shop in mass channels. Further, they 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, including daily food. For everything else, they 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.

Digital intimacy (data, mobile, and the Internet of Things [IoT])

Digital is revolutionizing how consumers learn about and engage with brands and how companies learn about and engage with consumers. Yesterday's marketing standards and mass channels are firmly on the path to obsolescence. Digital-device penetration, the IoT, and digital profiles are increasing the volume of data collected year after year, boosting companies' capabilities but also consumer expectations. Most FMCGs have started to embrace digital but have far to go, especially in adopting truly data-driven marketing and sales practices.

Some FMCG categories, particularly homecare, will be revolutionized by the IoT. We will see the IoT convert some product needs, like laundry, into service needs. And in many categories, the IoT will reshape the consumer decision journey, especially by facilitating more automatic replenishment.

Explosion of small brands

Many small consumer-goods companies are capitalizing on millennial preferences and digital marketing to grow very fast. These brands can be hard to spot because they are often sold online or in channels not covered by the syndicated data that the industry has historically relied on heavily.

But venture capitalists have spotted these small companies. More than 4,000 of them have received $9.8 billion of venture funding over the past ten years—$7.2 billion of it in the past four years alone, a major uptick from previous years (Exhibit 3). This funding is fueling the growth of challenger brands in niches across categories.

Retailers have also taken notice of these small brands. According to The Nielsen Company, US retailers are giving small brands double their fair share of new listings. The reason is twofold: retailers want small brands to differentiate their proposition and to drive their margins, as these small brands tend to be premium and rarely promote. As a consequence, small brands 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 make the category worth pursuing. Strong emotional engagement means consumers notice and appreciate new brands and products. A value chain that is easy to outsource makes it much easier for born-digital players to get started and to scale. Low shipment costs as a percent of product value make the economics work. And low regulatory barriers mean that anyone can get involved. Most consumer-goods categories fit this profile.

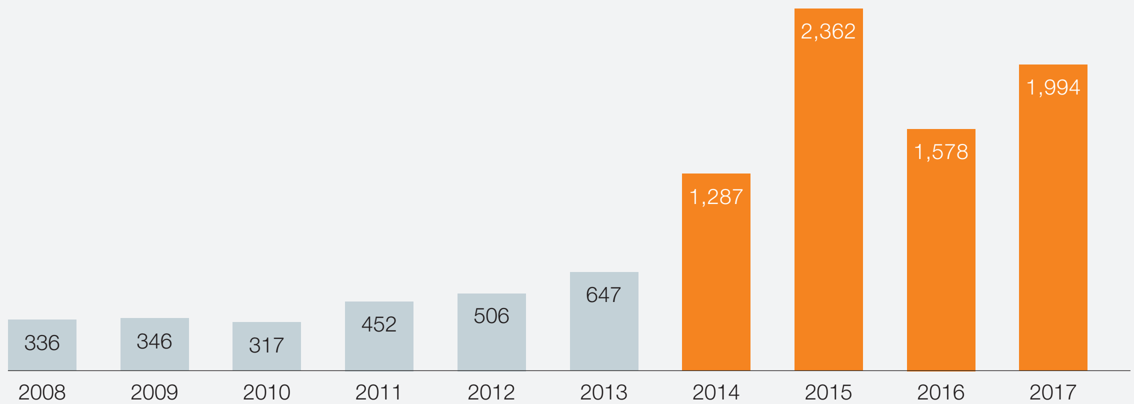
The beauty category in particular is an especially good fit, so the advanced explosion of small brands in this category is no surprise. In color cosmetics, born-digital challenger brands already represent 10 percent of the market and are growing four times faster than the rest of the segment. The explosion of small brands in beauty enjoys the support of significant venture-capital investment—$1.6 billion from 2008 to 2017, with 80 percent of this investment since 2014.

At the same time, digital marketing is fueling this challenger-brand growth while lifting the rest of the category, as beauty lovers find new ways to indulge in their passion. An astounding 1.5 million beauty-related videos are posted on YouTube every month, almost all of them user generated.

We believe that this bellwether category portends well for FMCG incumbents. After a few challenging years, the incumbent beauty players are responding effectively and are mobilizing to capitalize on the dynamism in their industry, particularly through

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

Source: Pitchbook Data; McKinsey analysis

greater digital engagement. They are innovating in digital marketing and running successful incubators. The year 2016 alone saw 52 acquisitions of beauty-related companies.

Better for you

For years, consumers said that they wanted to eat healthier foods and live healthier lifestyles, but their behavior did not change—until now. Consumers are eating differently, redefining what healthy means, and demanding more products that are natural, green, organic and/or free from sugar, gluten, pesticides, and other additives. Packaged-food players are racing to keep up, even as consumers are increasing pressure on the packaged-goods subsector by eating more fresh food.

Disruption of mass-retailer relationships

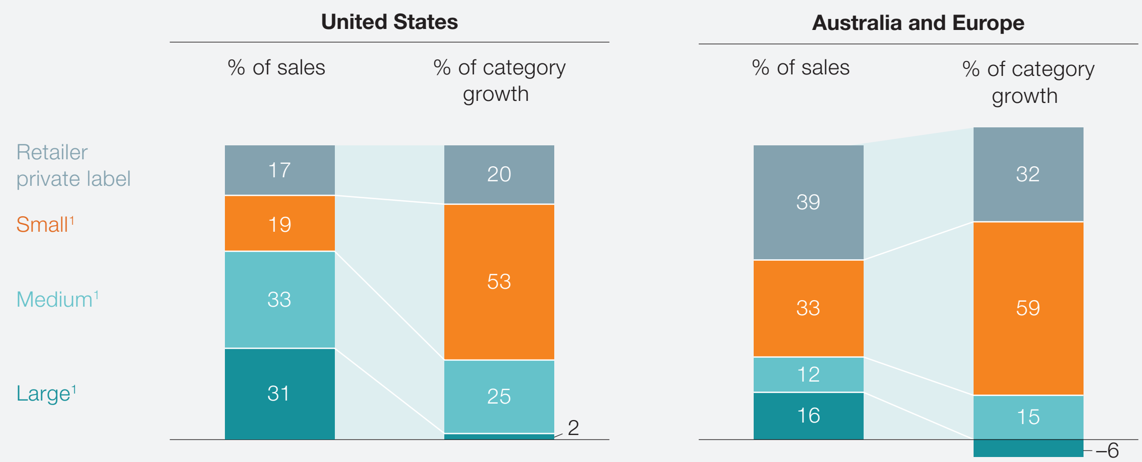
Three trends are fueling a fierce business-model battle in retail. The e-commerce giants are already the clear winners, while the discounter business model is also flourishing. Mass merchants are feeling the squeeze.

E-commerce giants

E-commerce giants Amazon, Alibaba Group, and JD.com grew gross merchandise value at an amazing rate of 34 percent a year from 2012 to 2017. As their offer attracts consumers across categories, they are having a profound impact on consumer decision journeys. This change requires FMCGs to rewrite their channel strategies and their channel-management approaches, including how they assort,

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 The Nielsen Company

price, promote, and merchandise their products, not just in these marketplaces but elsewhere. This disruption is in early days in markets other than China and will accelerate as the e-commerce giants increase their geographic reach and move in to brick-and-mortar locations. Amazon's push on private labels is a further game changer. To see the future, we can look to how China FMCG retailing has been revolutionized by Alibaba Group and JD.com and the profound impact Amazon has had on its early categories like electronics, books, and toys.

Discounters

ALDI and LIDL have grown at 5.5 percent from 2012 to 2017, and they are looking to the US market for growth. Discounters typically grow to secure market share of 20 percent or more in each grocery market they enter. This presence proves the consumer appeal of the format, which enables discounters to price an offering of about 1,000 fast-moving SKUs 20 percent below mass grocers while still generating healthy returns.

Mass-merchant squeeze

The rise of the e-commerce giants and the discounters is squeezing grocers and other omnichannel mass merchants. Together, the seven largest mass players saw flat revenue from 2012 to 2017. This pressure is forcing mass merchants to become tougher trading partners. They are pursuing more aggressive procurement strategies, including participating in buying alliances, getting tighter on SKU proliferation, and decreasing inventory levels. They are also seeking out small brands and strengthening their private labels in their quest for differentiation and traffic.

Disruption of developing-market category creation: 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 Procter & Gambles.

But local competitors will fight for that business in ways the multinational FMCGs have not seen in the past. As new competitors offer locally relevant products and win local talent, FMCG companies will need to respond—which will challenge the fairly centralized decision-making models that most of them use.

Further, channels in developing markets are evolving differently than they did in the West, which will require FMCGs to update their go-to-market approaches. Discounter-like formats are doing well in many markets, and mobile will obviously continue to play a critical, leapfrogging role.

Disruption of the synergy-focused operating model: Pressure for profit

Driven by activist investors, the market has set higher expectations for spend transparency and redeployment of resources for growth. Large FMCGs are being compelled to implement models such as zero-based budgeting that focus relentlessly on cost reduction. These approaches, in turn, typically reduce spend on activities such as marketing that investors argue do not generate enough value to justify their expense. While this approach is effective at increasing short-term profit, its ability to generate longer-term winning TRS, which requires growth, is unproven.

Disruption of M&A: Increasing competition for deals

M&A will remain an important market-consolidation tool and an important foundation for organic revenue growth in the years following an acquisition. But some sectors like over-the-counter drugs will see greater competition for deals, especially as large assets grow scarce and private-equity firms provide more and more funding.

Of course, the importance of these ten disruptive trends will vary by category. But five of the trends—the millennial effect, digital intimacy, the explosion of small brands, the e-commerce giants, and the mass-merchant squeeze—will deliver strong shocks to all categories (Exhibit 5).

A new model for creating value in a reshaped marketplace

To survive and thrive in the coming decades, FMCG companies will need a new model for value creation, which will start with a new, three-part portfolio strategy. Today, FMCGs focus most of their energy on large, mass brands. Tomorrow, they will also need to leapfrog in developing markets and hothouse premium niches.

This three-part portfolio strategy will require a new operating model that abandons the historic synergy focus for a truly agile approach that focuses relentlessly on consumer relevance, helps companies build new commercial capabilities, and unlocks the true potential of employee talent. M&A will remain a critical accelerator of growth, not only for access to new growth and scale, but also new skills (Exhibit 6).

Broader, three-part portfolio strategy

Today, most FMCGs devote most of their energy to mass brands. Going forward, they will need excellence in mass-brand execution as well as the consumer insights, flexibility, and execution capabilities to leapfrog in developing markets and to hothouse premium niches.

Sustaining excellence in the developed-market base

Mass brands in developed markets represent the majority of sales for most FMCGs; as such, they are "too big to fail." FMCGs 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 revamping media spend, particularly through programmatic M&A and understanding of return on investment, fine-tuning revenue growth management with big

Exhibit 5 **The historic value-creation model for fast-moving consumer goods will be affected in several ways.**

1 Excellence in mass-market product innovation and brand building, including premiumization	• Most category growth will be in niches • The portion of consumers that resist or reject mass brands will increase, especially in food products • Consumers' preferred method of learning about brands will be listening to each other • Small brands will thrive given their easy access to consumers, fit with millennial preferences, and pull from mass merchants seeking to differentiate themselves • New data sources will become more important than syndicated data for understanding the market and managing performance; having an accurate picture will become a competitive advantage • The Internet of Things will convert some product needs to service needs and change the consumer decision journey in many categories
2 Advantaged consumer access via mass-trade relationships	• The e-commerce giants will lead the trade • Discounters will grow to ~20% in most markets • Mass merchants will feel the "squeeze" and fight back with greater use of buying alliances, better use of owned data, and keenness for differentiation • Factors will push down pricing, which will require consumer-packaged-goods companies to live within a lower gross-margin structure
3 Developing-market category creation alongside rising incomes	• Developing markets will remain a great source of value creation; local players will fight for it • Channel evolution will leapfrog developed markets, especially in mobile
4 Operating model that drives consistent execution and achieves cost reduction	• Local relevance, consumer closeness, and speed will become more important than consistent execution as a driver of competitive advantage • Activist investors will continue to promote a cost agenda
5 M&A to consolidate markets and enable organic growth post acquisition	• Large assets will become scarce in some categories • Deep pockets of private equity will drive up valuations

data and tools like choice models, strengthening demand forecasting, and using robotics to improve shared services.

In addition to taking functional excellence to the next level, FMCGs will need to focus relentlessly on innovation to meet the demands of their core mass and upper-mass markets.

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

Further, FMCGs will need to gather their historically decentralized sales function, adopting a channel-conflict-resistant approach to sales. They will need to treat e-commerce as part of their core business, overcome channel conflict, and maximize their success in omni and e-marketplaces. Players like Koninklijke Philips that have weathered the laborious process of harmonizing trade terms across

Exhibit 6 **The new model for fast-moving consumer goods is a three-part portfolio strategy enabled by an agile operating model, 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 to drive insights, marketing spend, revenue management, production, and supply	Market leadership in digital/mobile	Targeted digital marketing
	Local market autonomy to fight microbattles and ensure local relevance	Full use of channels, including retailer e-commerce and direct to consumer
Joined-up, channel-conflict-resistant 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/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, including programmatic M&A skills, post acquisition

markets are finding that they can grow profitably on e-marketplaces.

Finally, FMCGs will need to keep driving costs down. We are following three big ideas on cost.

First, zero-based budgeting achieves sustained cost reduction by establishing deep transparency on every cost driver, enabling comparability and fair benchmarking by separating price from quality, and establishing strict cost governance through cost-category owners who are responsible for managing cost categories across business-unit profits and losses.

Second, touchless supply-chain and sales-and-operations planning replace frequent sales-and-operations meetings with a technology-enabled planning process that operates with a high degree of automation and at greater speed than manual processes.

Third, advanced analytics and digital technologies improve manufacturing performance by pulling levers like better predictive maintenance, use of augmented reality to enable remote troubleshooting by experts, and use of advance analytics for real-time optimization of process parameters to increase throughput yield of good-quality product.

Many of these changes will require strengthening technology—making it a core competency, not 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 to be digital. Success will also require empowering local leadership to compete with the local players looking to seize the market's growth potential. Local leaders will need decision rights on marketing as well as a route to market that is joined up across traditional, omni, and e-marketplace channels.

Hothousing premium niches

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

The demands of this three-part portfolio strategy call for a new, agile operating model that allows a company to adapt and drive relevance rather than prioritizing synergy and consistent execution above other objectives.

Agile operating model

Originating in software engineering, the concept of an agile operating model has extended successfully into many other industries, most significantly banking. Agile promises to address many of the challenges facing the traditional FMCG synergy-focused model.

Building an agile operating model requires abandoning the traditional command-and-control structure, where direction cascades from leadership to middle management to the front line, in favor of viewing the organization as an organism. This organism consists of a network of teams, all advancing in a single direction, but each given the autonomy to meet their particular goals in the ways that they consider best. In this model, the role of leadership changes from order-giver to enabler ("servant leader"), helping the teams achieve their goals.

An agile operating model has two essential components—the dynamic front end and the stable backbone. Together, they bring the company closer to customers, increase productivity, and improve employee engagement.

The dynamic front end, the defining element of an agile organization, consists of small, cross-functional teams ("squads") that work to meet specific business objectives. The teams manage their own efforts by meeting daily to prioritize work, allocate tasks, and review progress; using regular customer-feedback loops; and coordinating 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.

We also expect the FMCG operating model of the future to be more unbundled, relying on external providers to handle various activities, while FMCGs perhaps provide their own services to others.

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 FMCGs will develop the skills of serial acquirers adept at acquiring both small and large assets and at using M&A to achieve visionary and strategic goals—redefining categories, building platforms and ecosystems, getting to scale quickly, and accessing technology and data through partnership. These FMCGs will complement their M&A capability with absorbing and scaling capabilities, such as incubators or accelerators for small players, and initiatives to help their teams and functions support and capitalize on the changing business.

Moving forward

To determine how best to respond to the changing marketplace, FMCG companies should take the following three steps:

- Take stock of your health by category in light of current and future disruption, and decide how fast to act. This means asking questions about the external market: how significantly are our consumers changing? How well positioned are we to respond to these changes? What are the scale and trajectory of competitors that syndicated data do not track? Is our growth and rate of innovation higher than these competitors, particularly niche 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 and the time to redesign the operating model, applying agile concepts and incorporating the IT capabilities that offer competitive advantage. 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 and recruiting the talent required to execute the plan.

These efforts should proceed with controlled urgency. Over time, they will wean FMCG companies from reliance on the strategies and capabilities of the traditional model. Of course, as companies proceed down this path, they will need to make ever-greater use of the consumer insights, innovation expertise and speed, and activation capabilities that have led the industry to success and will do so again. ■

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