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Retail Practice

Turning private labels into powerhouse brands

Consumers have recently been snapping up private-label goods at grocery and mass retailers. Will this trend last? Only if retailers develop a compelling private-label strategy and operating model.

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October 2020

Private labels, or store brands, are having a moment. Early in the COVID-19 crisis, many consumer-packaged-goods (CPG) brands disappeared from store shelves due to panic buying and pantry loading. Some shoppers, not finding their preferred brands, instead bought private-label goods—and have continued to do so. The fact that private labels are frequently cheaper than national brands has helped, too, as financially strained consumers tighten their purse strings. These two advantages—high availability and low price—have made private-label products considerably more appealing to consumers during the COVID-19 pandemic.

The consumer shift toward private labels benefits retailers as well, since private labels are typically more profitable for them. Furthermore, high-quality private labels can gain a devoted following and become a powerful driver of customer loyalty to the retailer.

But will this private-label boom be a short-lived one? In the near term, are retailers at risk of disappointing first-time buyers of private-label products with a poorly-thought-out offering? And once the COVID-19 crisis abates, will most consumers abandon store brands and go back to buying their preferred brands? In our view, if retailers don't step up their private-label game, the answer to each of these questions will almost certainly be "yes."

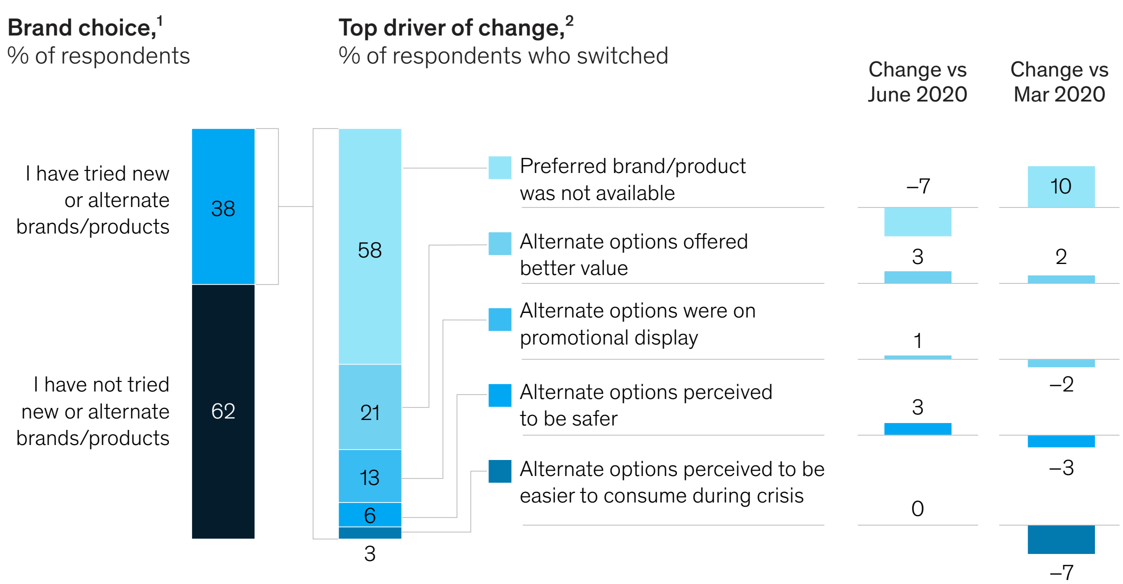
A shift in buying behavior

During the pandemic, consumers have proved quite willing to change their buying behavior. Our consumer surveys show that nearly 40 percent of US consumers have tried new products or brands since the onset of the COVID-19 outbreak. Much of the switching behavior was because of availability issues—some branded products were out of stock for weeks as CPG manufacturers struggled to meet sudden spikes in demand (Exhibit 1).

Exhibit 1

Nearly 40 percent of consumers have tried new products or brands during the COVID-19 crisis.

Consumer brand choice during COVID-19 crisis, Sept 2020 results



40% of respondents who switched brands will likely continue purchasing the new brand after the COVID-19 crisis (up from 12% in Mar 2020)[3]

Note: Figures may not sum to 100%, because of rounding.
[1]Question: Have you tried new or alternate brands/products during the current COVID-19 crisis that you do not usually purchase?
[2]Question: Why did you switch from the brands/products you usually purchase to new/alternate options?
[3]Question: After the COVID-19 crisis is over and the situation returns to normal, do you plan to switch back to the brands/products you usually purchased?
Source: McKinsey COVID-19 US Grocery Consumer Survey, conducted Mar 19–22, 2020 (n = 1,502), June 15–20, 2020 (n =1,981), and Sept 14–16, 2020 (n = 2,010)

Private labels have been one beneficiary of this switching trend. In a mid-September survey of more than 2,000 US grocery shoppers, nearly one in five said they've bought more private-label products during the COVID-19 crisis than they did precrisis. Company leaders at North American grocers and mass retailers tell us that they have indeed seen heightened demand for private-label goods.

When we asked consumers why they switched to private labels, more than 45 percent said price was the primary reason. That said, the second-most-cited reason was lack of availability of their preferred national brands (Exhibit 2).

Amid prolonged economic uncertainty, consumers' hunt for greater affordability might keep the private-label boom going for a while longer. But other signs point to the shift being temporary. Consumers could very well choose to switch back to national brands postcrisis, especially because many retailers' private-label strategies and offerings aren't explicitly designed to capture long-term customer loyalty.

Retailers can change that. And they should do so—fast.

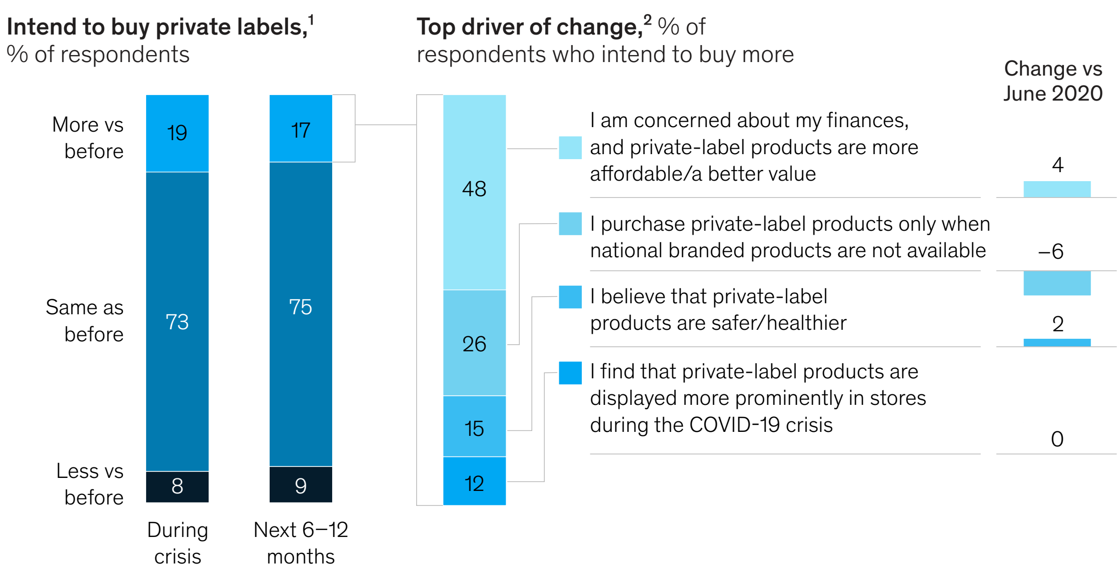
Private labels as a way to win customer loyalty

Even as retailers have introduced new private-label products and brands over the years, few have thought through the role of private labels in their businesses. Some private-label brands

Exhibit 2

Almost 20 percent of consumers are buying more private-label products; the primary reason is affordability.

Consumer purchase intent during COVID-19 crisis, Sept 2020 results



Note: Figures may not sum to 100%, because of rounding.
[1]Question: How many more private-/store-label products are you buying now (during the COVID-19 crisis vs before)?
[2]Question: How many more private-/store-label products will you buy in the next 6–12 months when the situation is back to normal vs before the COVID-19 crisis? What is driving the increase in private-label product purchase?
Source: McKinsey COVID-19 US Grocery Consumer Survey, conducted June 15–20, 2020 (n =1,981), and Sept 14–16, 2020 (n = 2,010)

and products come into being simply because, for instance, a vendor offers to make a product at a lower cost and higher margin rate than a national brand. The retailer agrees—but doesn't carefully define this new product's value proposition or the product's role in the assortment. Some retailers have been somewhat more deliberate in launching private labels: setting targets for margin and penetration rates, adjusting those targets as needed, and even making changes in their organizational structures to put more focus on private labels. But they haven't aligned on their aspirations or developed a robust strategy for these brands.

Retailers that seize this moment to reset their private-label strategies can translate short-term switching behavior into long-term customer loyalty. For some retailers, the private-label offering may have been successful in the pre-COVID-19 environment but now requires reevaluation. For retailers that haven't meaningfully invested in private-label capabilities, making bold moves is even more urgent.

Refine and pressure test your aspirations for private labels

Now is an opportune time for a retailer to define—or redefine—its aspirations for its store brands, based in part on the maturity stage of private labels in the markets in which it operates (see sidebar, "How private labels have evolved around the world"). Key areas in which to set aspirations and associated targets include brand awareness, customer perceptions, penetration, quality, value, profitability, and private labels as a driver of store loyalty. The next step would be a high-level assessment—for instance, through customer surveys, competitor scans, and financial analyses—to understand the gaps between current performance and aspiration.

Conduct a detailed diagnosis and gap assessment

Once a retailer has done a high-level assessment, it can then take a deeper look at five areas—namely, brand strategy, assortment and pricing, marketing and packaging, product design and sourcing, and organization and operating model—and develop an action plan in each.

Brand strategy

Research often reveals that consumers recognize private-label goods as lower-priced products but not as products that deliver on quality, innovation, or excitement. Furthermore, consumer perception of a private label can differ markedly across categories or departments: at some retailers, private-label diapers, say, are more expensive than the national brands whereas private-label soda is 20 percent cheaper than the national brands. Surveys have shown that even a retailer's own merchandising

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How private labels have evolved around the world

Leading retailers worldwide have shown that a robust private-label offering can be a core pillar of a store's value proposition.

Store brands are typically first introduced as a vehicle for enhancing a retailer's profit margins. They require lower marketing spend and overhead because they rely on store traffic and shelf position to secure sales. The products tend to be either at the opening price point and significantly cheaper than national brands (with certain quality or feature trade-offs), or me-too versions of leading national brands at lower price points.

In the least mature private-label markets, the target consumer segments are people on a tight budget looking for basic options, as well as savvy shoppers who relish the idea of buying national-brand equivalents for less money. In these markets, private labels help drive retailer margin and contribute to the overall price perception of the store—but they don't enhance loyalty to the store, especially if their quality is noticeably inferior to that of the national brand.

As the exhibit shows, most markets have evolved from this initial position.

Particularly in European countries and Canada, many retailers have become sophisticated owners of private labels, managing their private labels much like consumer-packaged-goods manufacturers do—with strict discipline around the unique value proposition of their brands and with clear standards and guardrails. In these markets, private labels frequently launch innovative products or provide elevated quality and features versus the national brands, telling a "more for the same price" value story. As this evolution has occurred, private labels have become a strong driver of store loyalty.

Exhibit

Markets for private-label products are at different stages of maturity.

Private-label maturity

	Optimization of core assortment	**Private-label portfolio management**	**Sophisticated private-label ownership**
Example markets	Brazil, Colombia, Mexico	Japan, United States	Canada, Germany, Spain, United Kingdom
Where to play	Price/value positioning in opening price point or national-brand equivalent segments, with high focus on categories where brands are less important or value is desired	Additional brands and subbrands to cover wider range of customer-need states, with ongoing focus on price/value	Brands with high awareness, advocacy, and stand-alone loyalty rivaling national brands as a reason to switch stores
How to win	• Build core range, focusing on me-too price/value opportunities within the category • Ensure quality is sufficient and communicated to customers • Optimize pricing to ensure best value consistently and preserve price gaps • Secure penny profit with discipline around sourcing	• Identify, prioritize, and target key consumer needs not covered by price/value alone (eg, premium, organic, healthy) • Communicate key enhanced benefits of new brands and subbrands through packaging, in-store execution, and marketing • Set clear pricing and promotional guardrails across brands based on relative brand strength	• Drive brand storytelling: innovation, origin and quality of ingredients, authenticity, etc • Refine brand architecture to capture missing tiers, customer segments, etc • Innovate systematically to differentiate and surprise/delight • Make owned brand "come to life" with merchandising, marketing, and packaging

and brand teams sometimes have a poor understanding of each brand's value proposition and apply it inconsistently.

Whether a retailer has chosen a "monobrand" strategy or maintains several private labels that cross price tiers and categories, it should clearly define for each brand (and sub-brand) a customer value proposition that meets a distinctive consumer need. This step may seem obvious and basic but is often overlooked. The retailer could then test the value proposition with consumers.

Equally important is the development of clear standards and guardrails. By communicating and reinforcing these guardrails, the retailer can equip its brand and category teams to bring the value proposition to life consistently at each customer touchpoint.

Answering the following questions can be instructive as retailers develop and refine their private-label strategies:

— What are each brand's target customer segments—and what are their relevant wants and needs?

— What is each brand's value proposition, and what distinct consumer need does it meet? Is the value proposition differentiated from that of national brands?

— In which categories can our private brands play, and how can they win?

— What guardrails and guidelines have we set to help teams execute on brand value propositions? How can we ensure that all stakeholders understand these guardrails?

— How are we monitoring compliance with these guardrails across categories with regard to price positioning, quality, innovation, and other critical dimensions?

Assortment and pricing

Historically, retailers haven't heavily marketed their private labels. Customers' impressions of many private labels are influenced largely by what they see on store shelves—and there, many retailers fail to make much of an impression. The proliferation of national-brand SKUs, along with the introduction of secondary and tertiary brands to fill white spaces, eventually waters down private labels' differentiation and renders the assortment architecture irrelevant. Missed opportunities in pack sizes, flavors, and other subsegments pile up when a retailer doesn't have a systematic process for refining the assortment architecture.

Setting and regularly enforcing price-gapping measures is particularly important for private labels, many of which attract consumers precisely because of perceived value. Ideally, retailers would systematically compare the price of each private-label SKU against internal and competitor benchmarks. Here, too, compliance with established guardrails becomes lax over time, national-brand promotions weaken the private-label value story, and—perhaps most egregiously—brands play at very different price tiers across categories, without clear messaging to support these disparities.

As they seek to address misaligned assortment and pricing, retailers could start with the largest categories, then launch a longer-term program to revisit the entire assortment. They would do well to consider the following questions:

— What is our process for rationalizing SKUs, especially when value propositions overlap? What low-share SKUs in our assortment might be negatively affecting our private label's value?

— What is our process for regularly identifying and addressing white-space opportunities (such as flavors and pack sizes) within the category?

— For each of our private-label products, what is the "reference" national brand for price and quality benchmarking? Is it the market leader, or a product that resonates most strongly with our customers?

— What are our price-gapping rules, and how regularly are we adjusting prices for promotions or competitor price changes?

- How can we ensure that we are consistently maintaining price positions across categories within brands, even when we run promotions?

Communication, marketing, and packaging
Although private labels have traditionally relied on price and shelf placement to drive purchase, leading retailers have recently been using cost-effective channels to communicate the story behind their store brands—for instance, how they source ingredients or where the products are made. In particular, sophisticated retailers are looking at the key drivers of purchase at a category level and ensuring fair-share presence. For example, one retailer is blogging about its private-label baby products on popular parenting websites and forums; another is seeking quality certification from the leading independent product-testing authorities. These and other actions help close the quality-perception gap that many private labels face.

Packaging, too, is becoming more important for conveying private labels' value proposition. In the past, private-label packaging tended to resemble the look and feel of national-brand equivalents. Leading retailers are now developing brand language on their packaging that not only draws shoppers' attention but also conveys the functional benefits of the brand. A leading private-label player in the value segment has added a prominent callout on its packaging announcing its clean ingredients, differentiating it from other value national brands.

Retailers ought to consider the following questions regarding communications, marketing, and packaging of private-label products:

- How are we making consumers aware of our quality parity (or advantages) versus the competition?

- In each category, what are consumers' primary sources of information and purchase drivers—and are we investing in those channels?

- How can we leverage our own channels (for example, point of purchase, store flyers, own website) to market our private labels?

- What, if anything, can we change in our packaging so that it is on par with the look and feel of the leading national and private brands?

- How can we design our packaging to convey quality and benefits (origin of ingredients, for instance)?

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Product design and sourcing

A retailer's private-label strategy—especially its choice of either focusing on me-too national-brand equivalency or introducing new features and benefits to a category—will, of course, greatly influence design and sourcing. Regardless of strategy, however, retailers would be wise to develop a mix of top-down product-design guardrails dictated by brand value propositions, and bottom-up category-driven priorities identified by the merchants who are typically closest to consumer needs and vendor opportunities.

In sourcing, a common misstep is to use a "price back" approach, whereby merchants set a price and margin target for the sourcing team. This approach typically leaves money on the table and reduces flexibility as market prices change. Because the approach focuses too greatly on margin percentage rates, the penny profit that a private-label product delivers may fall below that of a nationally branded product (especially when trade allowances are accounted for), making the consumer switch to the private-label product a losing proposition for the retailer.

Best-practice retailers have a clear, consumer-driven set of specifications and quality standards governing their private-label design and sourcing decisions—but, critically, they also have a mindset and key-performance-indicator (KPI) framework to drive toward lowest cost. Done right, sourcing excellence can often fund growth investments in the private-label program. Retailers could identify which product categories have the most attractive opportunities to improve penny profit and quality, and then develop new, savings-focused KPIs.

Retailers could also look into opportunities for innovation and differentiation in sourcing. As consumers become increasingly comfortable with buying private labels, retailers can more assertively introduce new products with features and benefits that surpass those of traditional CPG brands. Some private labels could even lead entire categories. After all, retailers have the advantage of a wealth of consumer insights; they see trends across brands, and therefore are privy to customer patterns and preferences that may not be visible to individual CPG manufacturers. Many retailers that exclusively or primarily carry private-label products have built fierce customer loyalty by becoming trendsetters, with their private labels providing a "halo" to their retail banner.

In their journey toward excellence in product design and sourcing, retailers could think about the following questions:

— What is our process and framework for aligning on design priorities? Does it allow for sufficient input from category teams?

— What guardrails have we set for design and quality requirements by category type?

— How can we speed up the product-design process so that it's agile enough to respond to trends and product opportunities?

— What are the sourcing team's KPIs? Are they oriented toward best total cost, and does the team revisit cost at least annually to make improvements?

— How should we track private-label product profitability versus the national brand at the penny level (rather than the margin-rate level) to ensure that consumer switching to lower-priced private-label goods is net profitable?

— In what categories is our private label mature enough for us to "get ahead" of CPG manufacturers by introducing innovative or differentiated product?

Organization and operating model

There's no one-size-fits-all model to support private labels. Retailers rely on a variety of operating models, ranging from highly centralized organizations with dedicated resources (typically including brand management, product design, sourcing, quality assurance, marketing, and consumer insights) to decentralized operating models in which merchandising teams own much of the strategy and execution.

Centralized teams are most critical in the early stages of private-label development, during which merchandising teams need intensive support and expertise to identify opportunities and execute the value proposition consistently. Centralized resources also play a crucial role in highly developed private-label markets where CPG-like functions manage differentiated brand standards and innovation pipelines. On the other hand, in markets with more modestly developed private labels, where the focus is typically on price differentiation and me-too offerings, we've found that it's most effective for a lean, centralized team to develop price and quality guardrails while category teams take the lead on execution.

At a minimum, a centralized sourcing and quality-assurance team would be best positioned to define specifications for newly designed product, select vendors, and make the optimal trade-offs between cost and quality. Leading retailers are also adding some level of brand stewardship to central teams to ensure consistency in execution across categories.

To figure out its optimal organizational structure or operating model, a retailer could consider the following questions:

— What steps can we take to clarify roles, responsibilities, and decision rights in every part of our private-label value chain?

— What is the role of the centralized private-label team and is it commensurate with the needs of the brand? How can we further clarify guardrails and standards to better enable category teams?

— As our brands grow, what is the optimal level of brand stewardship at the center to ensure that each brand's customer value proposition retains its integrity and is executed consistently?

The surge in private-label sales has been good news for retailers. Will consumers stick with private labels postpandemic? The answer isn't crystal clear yet—but retailers can certainly influence the outcome. For those retailers that set bold aspirations and move quickly to fill any capability gaps, private labels can soon become powerhouse brands.

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The authors wish to thank Anuja Desikan Perkins, Jane Fuerst, and Bartosz Jesse for their contributions to this article.

Designed by McKinsey Global Publishing