

NOVEMBER 2017



© Keiko Morimoto

CONSUMER PACKAGED GOODS/RETAIL

Retailing in the Middle East: How to recapture profitable growth

Major structural shifts in the region will compel retailers to transform their businesses both commercially and operationally.

Peter Breuer, Gemma D'Auria, Abdellah Iftahy, and Tarek Mansour

For much of the past 15 years, retailers in the Middle East—particularly those in the Gulf Cooperation Council (GCC) countries—have benefited from a favorable macroeconomic environment. Grocery, apparel, electronics, and other retail segments have achieved profits and returns above the global industry average.

But a confluence of structural shifts is challenging these retailers' revenue and profitability. The decline in oil prices, geopolitical instability, and the rapid evolution of digital technology have all had a profound effect on Middle Eastern governments, consumers, and businesses. Retailers are no exception: in every segment, growth has slowed significantly even as margins are being squeezed.

To adjust to these structural shifts—the Middle East's "new normal"—retailers must undertake both

a commercial and an operational transformation. The good news is that GCC retailers haven't yet pulled a number of levers that have proved effective for retailers in other parts of the world. In this article, we discuss three of the levers that can most rapidly boost a retailer's financial performance. The potential impact: an increase of 15 to 20 percent in sales and of 5 to 10 percent in profits.

Years of above-average growth

Between 2011 and 2015, GCC retailers captured above-average revenue growth, margins, and returns (Exhibit 1). One driver of this high performance was the ability to charge higher prices than are typical in other markets. Consumers in the region were willing to spend their fast-growing disposable incomes, which were rising at two to three times the global average. Certain GCC countries had outside proportions of millionaire

Exhibit 1

In the past five years, retailers in the Middle East have outperformed their global peers.



¹ Compound annual growth rate.

² Earnings before interest, taxes, depreciation, and amortization.

³ Return on invested capital. Gulf Cooperation Council benchmarks based on publicly listed players.

⁴ Based on mass apparel segment only (average of franchises and own brands).

⁵ Based on franchise players.

⁶ Based on average of 2013-15.

Source: Broker reports; Euromonitor; expert interviews; Thomson Reuters Eikon; McKinsey Corporate Performance Analysis Tool

households. Elevated spending levels in Qatar, the Kingdom of Saudi Arabia (KSA), and the United Arab Emirates (UAE) drove the strongest period of growth that the Middle East had ever seen.

Another boon for the region's retailers was limited competition. Import tariffs and local-ownership

laws discouraged foreign competitors from entering the market. Additionally, cheap inputs—including low-cost expatriate labor and heavily subsidized utilities—kept costs down for retailers. Foreign workers, who typically earned less than 50 percent of local workers' wages, constituted more than half of the workforce in the KSA and more than

The Middle East's new normal will challenge retailers' top and bottom lines.

70 percent in Qatar and the UAE. Fixed prices for electricity and petroleum were as much as 95 percent lower than prices in the rest of the world.

During this period, GCC retailers innovated. They opened vast shopping malls that have become consumer destinations. They introduced new retail concepts—examples include the luxury children's store Level Kids (which combines designer clothing with specialized services such as a spa and concierge) and Café Bateel, a gourmet-food store and restaurant. They built franchises of renowned global brands. Some invested heavily in capabilities like talent management and leadership development.

How times have changed

But today, with oil prices only slightly recovered from a 13-year low and geopolitical risks abounding, retailers find themselves in a vastly different business environment. The region's governments, which rely heavily on hydrocarbon-related revenues, are in belt-tightening mode and making major changes in fiscal policy—such as introducing a new 5 percent value-added tax and new “sin” taxes (100 percent on tobacco products and energy drinks, as well as 50 percent on soft drinks); reducing energy and utility subsidies, thereby pushing up prices by more than 20 percent across the Middle East; and slashing capital expenditures. The KSA, for instance, cut \$65 billion from its budget by canceling, limiting, or postponing planned projects.

At the same time, retailers' costs are rising, partly as a result of new labor-localization laws, market-priced utility costs, and new tax measures. The KSA is charging higher visa fees for expats and introducing

new laws requiring retailers to hire Saudi nationals for approximately 1.5 million retail jobs. Labor costs are therefore expected to rise by as much as 15 percent. Subsidy cuts are expected to increase the cost of utilities, such as power, electricity, fuel, and water, by as much as 15 to 20 percent.

Consumers, seeing stagnation in their real disposable incomes, are increasingly cutting back on spending and looking for ways to save money (Exhibit 2). The latest McKinsey consumer-sentiment survey reveals that in both the KSA and the UAE, three out of four consumers are worried about job losses. Almost half of consumers said they are delaying purchases, and more than a third said they are living paycheck to paycheck.

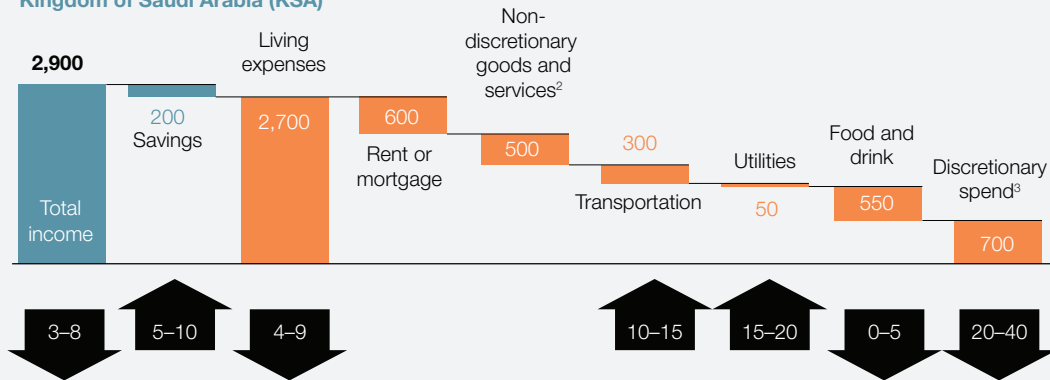
Furthermore, competition is intensifying, both offline and online. Per capita retail square footage has increased, and real-estate productivity has declined. The impact of online platforms such as Amazon and Alibaba is being felt in the Middle East—for instance, Amazon recently acquired Souq.com, the region's leading e-commerce player.

This new normal will challenge retailers' top and bottom lines. We expect the slowdown to continue at least through 2018. For example, grocery sales are projected to grow between 2 and 5 percent in 2018, well below the 8 percent growth that the sector achieved in 2015. We expect lower growth in apparel and electronics as well, throughout the region. As for profitability, grocery and electronics retailers could see a 3 to 5 percent decline in EBITDA margins, while apparel retailers could witness a drop of 7 to 10 percent.

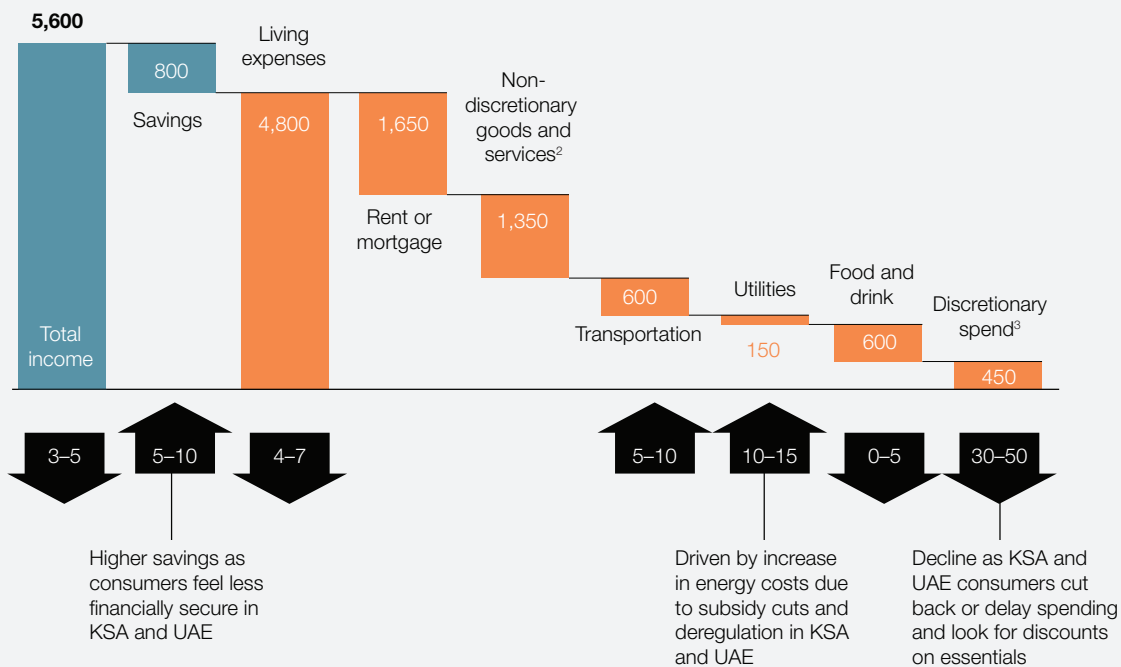
Exhibit 2 Consumers, under financial pressure, are cutting back on their retail spending.

Household monthly income and consumer expenditure, \$, % impact under new normal

Kingdom of Saudi Arabia (KSA)¹



United Arab Emirates (UAE)⁴



¹ Based on income and expenditure distribution in 2013 for Saudi and non-Saudi households.

² Includes healthcare, telecom, education, and other personal goods and services.

³ Includes clothing, footwear, home furnishings and appliances, recreation, hotels, and restaurants.

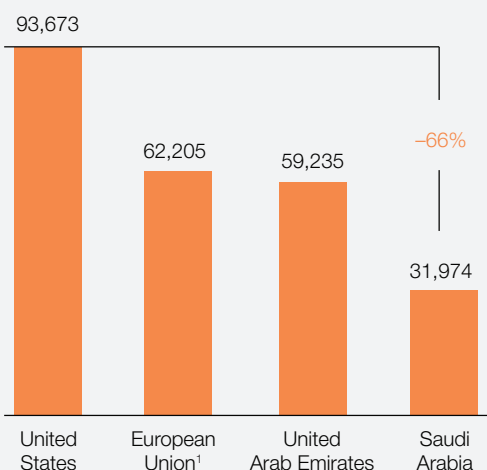
⁴ Emirati and non-Emirati households, 2014 data.

Source: Dubai Statistics Center; Euromonitor; General Authority of Statistics, Kingdom of Saudi Arabia; GCC Statistical Center; Statistics Centre Abu Dhabi; McKinsey analysis

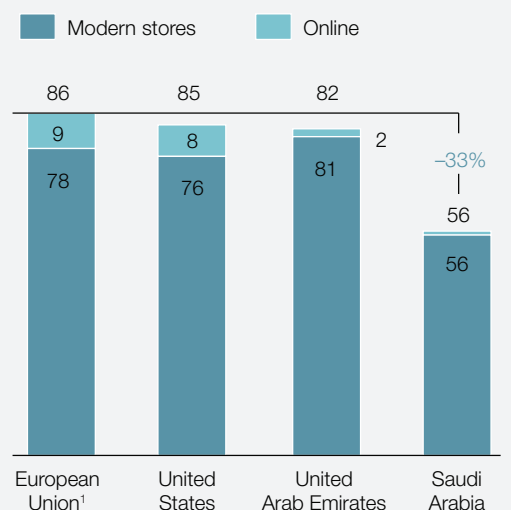
Exhibit 3

Gulf Cooperation Council retailers lag behind international peers in productivity and modernization.

Labor productivity retail and wholesale, 2013,
Value per worker, \$ (market-exchange rates
at 2013 prices)



Modern-trade penetration in grocery, 2014,
% share of total trade



Note: Figures may not sum because of rounding.

¹ Average of France, Germany, and United Kingdom.

Source: Central Department of Statistics and Information, Saudi Ministry of Economy and Planning; Central Intelligence Agency; EU KLEMS; IHS Global Insight; International Monetary Fund; World Bank; UAE National Bureau of Statistics; *Retail and wholesale: Key sectors for the European economy*, Institute of Retail Management, Saïd Business School, University of Oxford, April 2014; McKinsey Global Institute analysis

What's needed now: A commercial and operational transformation

These structural shifts call for decisive action on both the commercial and operational fronts. Fortunately, there remains much untapped potential: GCC retailers lag far behind their international peers in labor productivity and modernization levels (Exhibit 3). The gap between the United States and the KSA, for instance, is 66 percent in retail and wholesale labor productivity. Modern trade accounts for more than 80 percent of grocery sales in the UAE, but for less than 60 percent in the KSA and the region as a whole.

That means retailers in the Middle East have room to pull a wide-ranging set of commercial and operational levers. In our experience, levers that address one or more of three transformation imperatives—namely, developing a distinctive value proposition, pursuing strategic advantage in a functional area, and zeroing in on immediate sources of value—can be particularly powerful.

Develop a distinctive value proposition for customers

In light of fiercer competition and shifts in consumer sentiment, retailers in the Middle East must develop customer-centric offerings that make

them stand out from the pack. Deep knowledge of the customer is a prerequisite for creating a customer-focused assortment, a finely targeted pricing and promotions model, and seamless omnichannel services.

Example lever: Assortment optimization

A consumer-centric assortment is one major component of a distinctive customer value proposition. Too often, retailers make supplier-centric assortment decisions—they stock the products and brands that their favored suppliers offer or that are sold at the best prices by their suppliers. Instead, retailers need to understand how consumers decide what to buy: which products they view as substitutes for other items, and what factors matter to them most when they buy specific products. Such consumer insights can be generated through market research, loyalty-card data mining, and the use of predictive-analytics tools. These insights should then inform the assortment at each store to ensure that the breadth of local customers' needs are covered.

A leading grocery retailer undertook an end-to-end assortment optimization, removing underperforming or redundant SKUs in each

category and adding new high-potential SKUs to meet unaddressed customer needs. The retailer embedded an innovative big data solution—which regularly generated insights about consumer behavior—as part of its new processes. The impact was an 11 percent increase in sales from space reallocation and improved SKU lists, as well as a 2 percent margin improvement.

Create strategic advantage by excelling in one or more functions

Another avenue for recapturing profitable growth in the Middle East is to outperform competitors in one or more functional areas. The choice will depend largely on the competitive landscape. Which functions do competitors typically neglect or underinvest in? Which carry the most potential and will truly set the company apart? For instance, Middle Eastern retailers might decide to make bold moves in the recruitment and retention of top talent, in building digital and analytics capabilities, or in strategic sourcing.

Example lever: Supplier negotiations

If a company decides to focus on strategic sourcing, one high-impact capability is supplier negotiations. Data-driven negotiations could reduce cost of



goods sold and yield margin improvements of 3 to 5 percent, which can then be reinvested in innovation and growth initiatives. Best-practice retailers develop comprehensive vendor and category playbooks containing detailed vendor profiles, sales and margin data, discounts, and analytics on vendor performance, allowing them to build a wide range of performance-based “asks” and arguments. The playbooks also create transparency on promotions and pricing performance and associated vendor funding. Leading retailers invest in consumer data and advanced analytics so that they’re equipped to challenge suppliers’ claims about the importance and role of brands. Just as important, they make sure to build the negotiation skills of buyers and category managers through certification processes, thorough training, and frequent coaching.

Home in on immediate sources of value

To create momentum and rapidly reset their business for the Middle East’s new normal, retailers must capture quick wins—they must launch initiatives that can make a meaningful difference to the top and bottom lines within a mere three to six months. Working-capital management; the optimization of selling, general, and administrative (SG&A) costs; and lean store operations are some operational initiatives that can yield quick wins.

Example lever: Marketing-spend effectiveness

We’ve seen retailers in the region reduce SG&A costs by as much as 20 to 30 percent. Some retailers have found that improving marketing-spend effectiveness is an immediate source of value, not only for reducing SG&A spending but also for increasing sales and deepening customer relationships. To improve marketing-spend effectiveness, leading retailers do the following:

Reallocate spend to strategically important brands and channels. Retailers tend to dedicate the bulk of their marketing dollars to older, established brands

or channels that they have invested in historically rather than to newer, high-growth brands and new digital channels. Instead, retailers should regularly review their spending and reallocate marketing dollars to align them with the strategic importance of each brand and channel.

Emphasize “working spend.” All marketing dollars used for purchasing media time or space, including above-the-line and below-the-line advertising, constitute working spend. Nonworking spend encompasses marketing expenses, such as creative fees, used to create the advertisement itself. Best-in-class companies ensure that their nonworking spend doesn’t exceed 20 percent of total marketing spend. Retailers should reevaluate their marketing mix and shift more of their budgets toward working spend, which has a direct impact on reach.

Optimize procurement spend. Finally, leading companies monitor and refine their procurement of marketing services. They renegotiate agency contracts and consolidate dispersed accounts with agencies that offer similar services, thereby reducing their spending while increasing their bargaining power.

A multibillion-dollar electronics retailer had been allocating most of its media spend to newspaper inserts and television. The company was seeing declining traffic, even with an above-average ad-sales ratio. With the help of a granular media-mix model, the retailer cut back on underperforming legacy spend and increased digital spend—in particular, paid search. The return on investment of its media spending increased by more than 20 percent, and sales grew by over \$40 million, even as the company reduced its overall marketing budget by 15 percent.

The pace of implementation

Depending on the urgency of change, retailers can adopt different implementation models and

proceed at different speeds. Retailers netting above-average performance might consider pursuing a set of targeted actions in carefully sequenced phases, each lasting three to six months, starting with quick wins. They should leverage and improve existing structures and systems rather than starting from scratch. They should also focus on building capabilities during implementation, to ensure lasting change.

For retailers with highly challenged bottom lines, the need for action is obviously more urgent. A full-scale organizational transformation taking place over 12 to 18 months, when multiple levers are pulled simultaneously, may be needed. A transformation office would oversee the program, with each initiative having a distinct owner.



In the Middle East's new normal, retailers that take a business-as-usual approach will see tempered growth and lower profitability. To win, companies will need to make both commercial and operational changes. The time to act is now. ■

Peter Breuer is a senior partner in McKinsey's Cologne office; **Gemma D'Auria** is a partner in the Middle East office, where **Abdellah Iftahy** is an associate partner and **Tarek Mansour** is a partner.

The authors wish to thank Stuti Khaitan, Mohamed Matar, and Min Kyeong Yoon for their contributions to this article.

Copyright © 2017 McKinsey & Company.
All rights reserved.