McKinsey&Company

Consumer Packaged Goods Practice

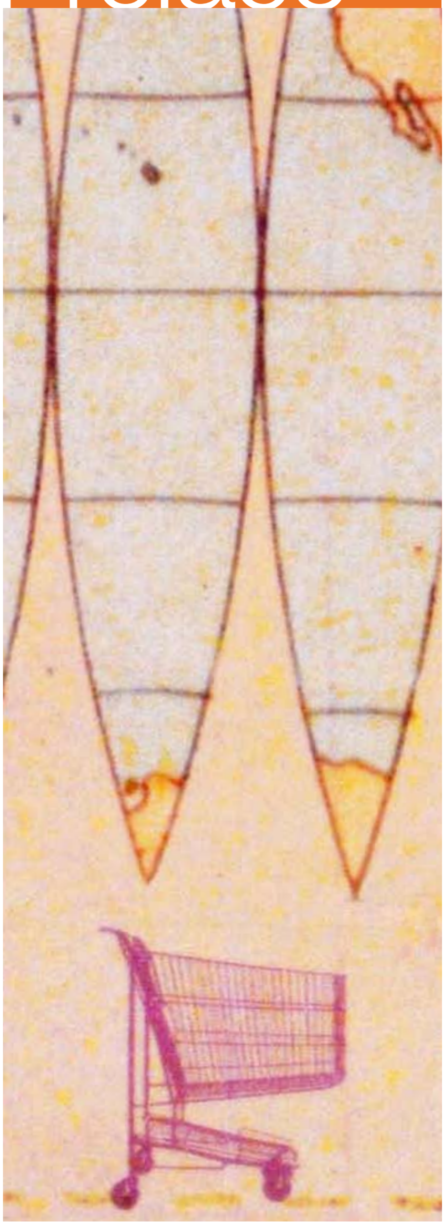
The decade ahead: Trends that will shape the consumer goods industry

Consumer Packaged Goods practice

The decade ahead: Trends that will shape the consumer goods industry

Ishan Chatterjee
Jörn Küpper
Christian Mariager
Patrick Moore
Steve Reis

Preface



The consumer-packaged-goods (CPG) industry's growth over the past quarter century has been nothing short of exhilarating. CPG companies have launched innovative products to meet an ever-growing array of human needs and desires. They have expanded rapidly into the burgeoning consumer markets of the developing world. And to make this breakneck growth possible and profitable, they have aggressively built global scale along every part of the value chain. These strategies, along with increased margins and weighting of portfolios toward fast-growing categories, have delivered stellar shareholder returns.

But the past is no guide to the future. Over the coming decade, upheavals in global consumer and supply markets are likely to produce as many losers as winners among CPG companies. For example, Asia will overtake the West as the main consumer market, and it will demand new levels of value and innovation from CPG players. Rising Internet penetration could upend traditional sales models. Globalized trading and natural-resource shortages could combine to usher in a new age of supply chain volatility.

In this article, we profile an analytical approach, developed by McKinsey's CPG practice, that allows executives to filter the myriad potential future trends to anticipate the few that could truly affect their company's competitive advantage. We then apply the approach to the CPG industry in aggregate, underlining the forces most likely to move the needle on value creation over the coming decade and pointing to the strategic questions that CPG companies must answer if they are to profit from these forces.

1

The strategic choices behind the industry's success

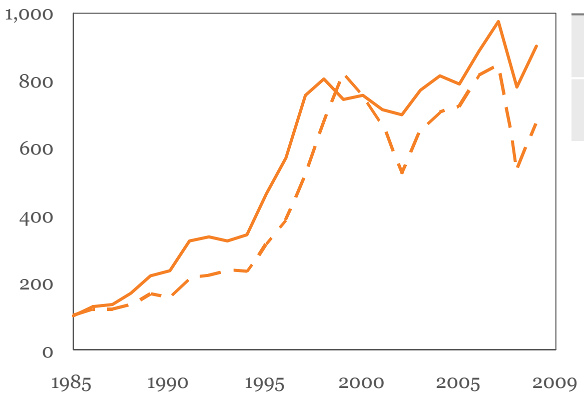
Before assessing the trends of the future, it is worth asking what has driven the industry's extraordinary performance in recent decades. US-listed CPG companies, for example, have increased total returns to shareholders (TRS) by an annual average of 10 percent over the past 25 years, outperforming not only the broader S&P 500 index but also high-growth industries such as information technology, energy, and telecom (Exhibit 1).

To be sure, this growth has taken place on the back of steadily rising incomes and population, particularly in emerging markets. But leading CPG players have not simply followed economic and demographic trends: they have actively anticipated them in their strategies and investment choices.

Constant innovation, along with a knack for passing on input-cost increases, has allowed the industry to boost its margins significantly.

Exhibit 1 Since 1985, the CPG industry has significantly outperformed the S&P 500

Weighted average CPG total return to shareholders (TRS) index vs S&P 500 TRS index[1]
1985 = 100%, adjusted for inflation



Compound annual growth rate (CAGR)
%
1985–2009

CPG	10.0
S&P 500	8.6

1 US-listed companies with real revenue (2003 currency) of more than $1 billion in any of the past 25 years
Source: Corporate performance analysis tool (CPAT); McKinsey analysis

To start, the industry has been relentless about new-product innovation. In the US grocery channel, for example, the number of SKUs has grown by 50 percent in just the past seven years.[1] Constant innovation, along with a knack for passing on input-cost increases, has allowed the industry to boost its margins significantly.

Further, CPG companies have expanded rapidly beyond their traditional Western bases. Emerging markets have contributed more than half the global revenue of the Coca-Cola Company since 2006, and almost half of PepsiCo's 2009 revenue was generated outside of the United States. At the same time, CPG companies have aggressively shaped their portfolios to increase the proportion of the fastest-growing and most profitable categories, creating considerable "momentum growth." Witness Nestlé's recent acquisitions in high-growth food categories such as baby food (Gerber), pet food (Purina), and frozen pizza (from Kraft).

To make this expansion possible—and profitable—CPG players have invested heavily in building global scale along every part of the value chain, including R&D, marketing and sales, procurement, manufacturing, and distribution. Unilever's ice-cream business is a salient example: it has rolled up its fragmented brands under the "heart" umbrella brand, established a single global ice-cream headquarters in Italy, and consolidated manufacturing in 16 plants worldwide. Even over the tumultuous last three years, CPG companies have performed well, thanks in large part to their diversified exposure to faster-growing emerging markets and their longer-term pursuit of scale and efficiency.

1 Food Marketing Institute, *The Food Retailing Industry Speaks 2010*

2

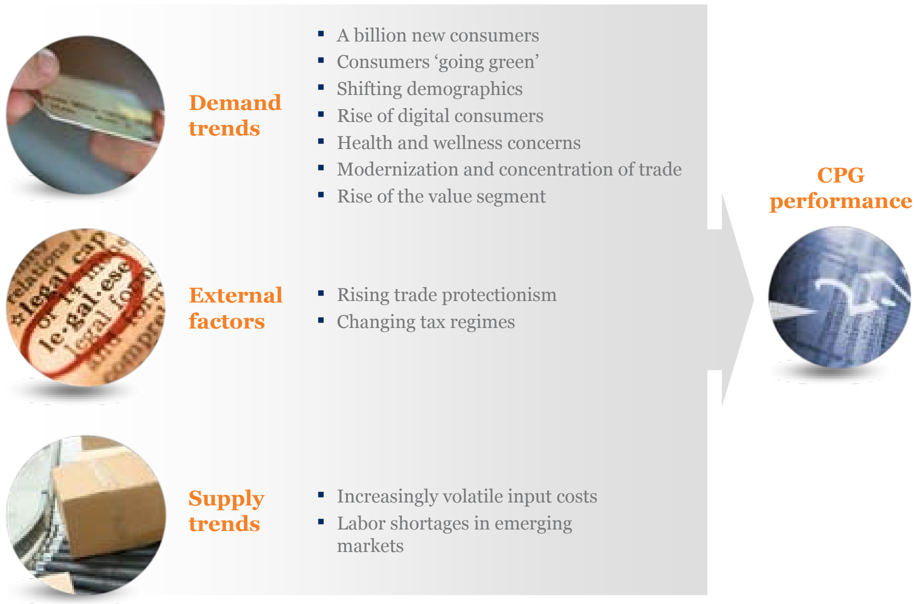
Have the rules of the game changed? A framework to analyze future trends

"The only constant is change," in the words of the ancient Greek philosopher Heraclitus. The upheavals in global consumer, retail, and supply markets over the coming decade threaten to wreak havoc on established business models and marketing approaches—and promise huge rewards for those best able to anticipate new opportunities.

How should CPG companies go about analyzing these forces and prioritizing those with the greatest likely impact on their own competitive advantage? McKinsey has developed an analytical methodology to help executives provide fact-based answers to these questions.

Here we provide a snapshot of the methodology, filtering an array of global trends to prioritize the few that will have the greatest impact on the profits of the CPG industry in aggregate over the coming decade. For an individual company or a particular category, a tailored version of this filtering exercise would yield distinct results.

Exhibit 2 Trends that could influence performance over the next decade



In our industry-wide analysis, we considered 11 global trends (Exhibit 2) across the demand side (for example, the rise of the value-orientated consumer segment), the supply side (say, increasingly volatile input costs), and the external environment (for instance, rising trade protectionism). While not exhaustive, this list includes the principal forces likely to affect the CPG industry as a whole. An analysis tailored for a particular company would include specific regional or sector trends, such as food-industry regulations to prevent obesity.

Our next step was to prioritize these 11 trends. First we sized each trend according to its likely impact on CPG companies' gross profits.[2] Then we evaluated the likelihood of the occurrence of each trend—gauging the momentum behind it, its resilience to external shocks, and the degree to which analysts and stakeholders are aligned on it. Finally, we assessed the importance attributed to each trend by CPG companies in their public communications.

Over the coming decade, upheavals in global consumer and supply markets are likely to produce as many losers as winners among CPG companies.

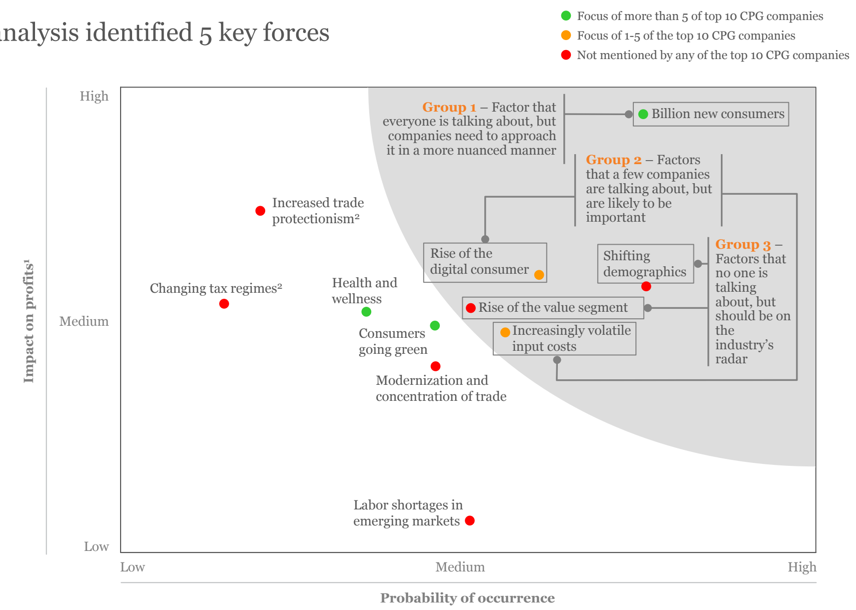
[2] For the sake of this analysis, we assumed that currencies will maintain their current relative valuations through 2020.

Through this filtering process, we identified five trends that are both highly probable and likely to have large impact on industry profits (Exhibit 3):

- A billion new middle-class consumers in emerging markets
- The rise of the digital consumer
- The shift to value
- The impact of demographic shifts, including aging, on consumption patterns
- Increasingly volatile input costs, driven by natural-resource shortages and the emergence of fewer, bigger suppliers

This is not to say that the other trends won't matter in the decade ahead. For example, green consumerism could combine with regulation to prompt CPG companies to reduce their impact on the waste stream by greatly reducing packaging. But in shaping strategy, companies need a fact-based way to rank and quantify trends for their likely impact on profits. By this measure, our analysis suggests that green trends and other headline-grabbers such as health and wellness will have less impact on global CPG value creation than the five major trends above.

Exhibit 3 Our analysis identified 5 key forces

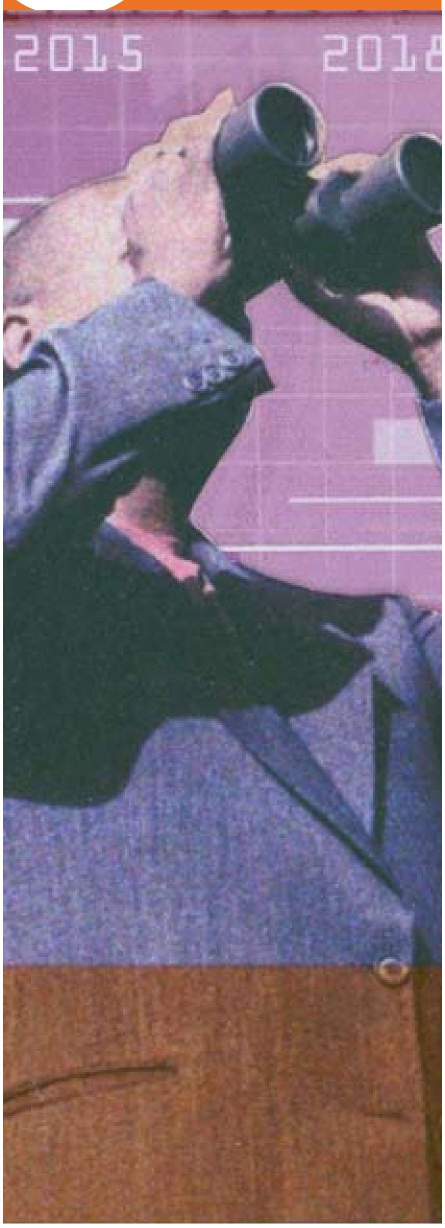


1 Classification guide: high = profit at stake >$300 billion; medium = profit at stake between $100 billion and $300 billion; low = profit at stake <$100 billion
2 Please note that these factors have not been sized due to the number of variables involved; these are estimates of likely impact
Source: McKinsey analysis

3

Five forces that will shape the industry's future

How, then, will each of these five trends shape the industry's fortunes over the next decade? And what are the strategic questions that CPG companies must answer if they are to unlock the value-creation potential that each of these trends offers? Let us consider each trend in turn.

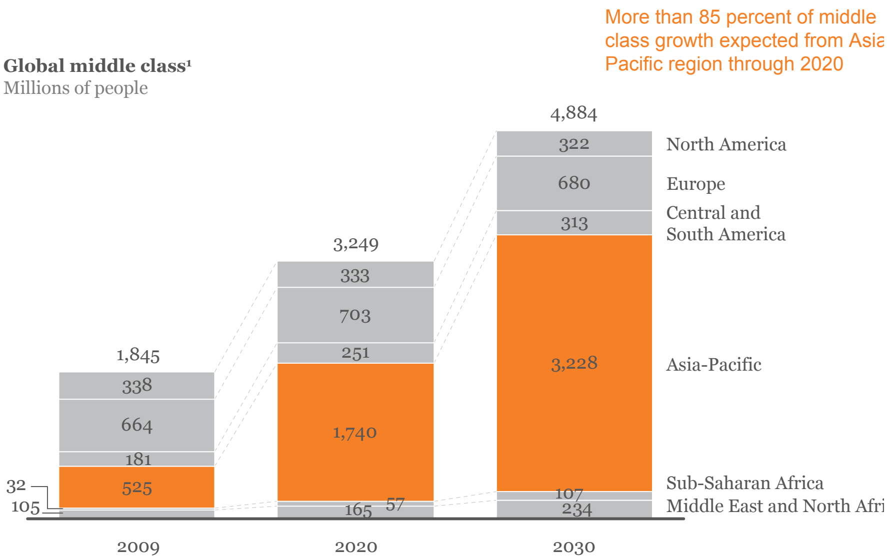


The upheavals in global consumer, retail, and supply markets over the coming decade threaten to wreak havoc on established business models and marketing approaches—and promise huge rewards for those best able to anticipate new opportunities.

A billion new consumers in emerging markets

This decade marks the tipping point in a fundamental long-term economic rebalancing. In the coming years, the growth of emerging markets will continue to outstrip that of the developed world by a wide margin. While the emerging countries in Asia—most notably China, India, and Indonesia—already had a significant share of global growth (18 percent) throughout the last decade, this growth share is expected to increase to nearly 30 percent in the next decade. As a result, the global middle class will expand dramatically: by 2020, there are expected to be more than 1 billion new consumers spending between $10 and $100 per day[3] (Exhibit 4).

Exhibit 4 The global middle class will add more than 1 billion people by 2020



1 Global middle class defined as daily expenditures between $10 and $100 per person in purchasing parity terms.
Source: Organization for Economic Co-operation and Development (OECD) Development Centre

3 Organisation for Economic Co-operation and Development (OECD) Development Centre, *The Emerging Middle Class in Developing Countries*, January 2010

Nearly everyone agrees on the importance of this trend, but understanding these new consumers and meeting their needs will be no simple matter for CPG players. Those who get it right stand to earn tremendous competitive advantage. Success factors will include the selection of categories and markets—to ensure that the company builds a leading position everywhere it plays—as well as segmenting the billion new consumers and innovating to meet their needs.

Consider the example of Wrigley chewing gum in China: the company has captured 40 percent of a fast-growing category already worth $2 billion. Its tactics include regular launches of products tailored to Chinese consumers, such as gum flavored with herbal essences and grapefruit; intensive consumer education to emphasize chewing gum's health benefits; and building a presence in the millions of small outlets where Chinese consumers typically shop.

Further, winning CPG companies are likely to be those that create value-oriented products. In China's ready-to-drink coffee market, for example, Nestlé has reduced prices by 30 percent. To make this possible, it has cut its costs by establishing a local supply base in Yunnan, and its sourcing is now 99 percent Chinese. In India, Cadbury has introduced products at low price points (such as its Perk brand) to attract more consumers to the chocolate category. However, as emerging markets account for an increasing proportion of CPG sales, companies will struggle to maintain their margins. Building scale will be one way of doing so; skillful segmentation of emerging-market consumers will be another.

Within China's wealthy population, for example, McKinsey research has identified seven distinct segments, ranging from the "flashy," who care about showing off exclusive brands but are willing to purchase counterfeit goods, to the "urbane," who care more about quality and refuse to purchase counterfeit products.[4] Across emerging markets, thoughtful segmentation will reveal many opportunities to create value—and build healthy margins—by meeting specific consumer needs.

Finally, CPG companies with Western roots will need to consider how the rise of emerging-market consumers might affect—and transform—their own organizations. For a company with, say, 70 percent of its sales in China and India by 2020, would it still be appropriate for the board to be dominated by Westerners and the headquarters to be located in Europe or North America?

In the coming years, the growth of emerging markets will continue to outstrip that of the developed world by a wide margin.

[4] McKinsey Insights China; Yuval Atsmon, Vinay Dixit, Max Magni, and Ian St-Maurice, "China's new pragmatic consumers," *McKinsey Quarterly*, October 2010.

The rise of the digital consumer

While technology has played a key role in the consumer goods industry's growth, it will be truly disruptive in the coming decade. In figuring out how to win in this new digital world, CPG companies face some major strategic questions—including how to build a successful business through online retail channels, how to build brands and categories in a socially networked world, and how to exploit technology-driven opportunities to understand consumers more deeply and connect with them more often.

The proportion of sales via online channels may be reaching a tipping point. In the United States, e-commerce now represents a $155 billion market, an estimated 6 percent of total retail sales.[5] In the United Kingdom, as many as one-third of adults say they now regularly shop for food online;[6] the same is true in Germany for apparel.[7] In China, the online retail market has more than doubled in each of the last three years and could exceed 1.3 billion renminbi ($200 million) by 2013.

To capture their fair share of this rapidly growing channel, CPG companies must raise their game with online retailers. They must work in close partnership with retailers to manage their online shelf space (including how prominently their products appear on Web listings), run joint targeted campaigns, and in general expand the category online.

There may also be the opportunity to sell directly to consumers. Manufacturers in other consumer-facing industries have successfully shifted consumers to e-commerce, allowing them to conduct transactions and even customize products on branded sites. CPG companies must make a strategic choice on whether and how to follow suit. Some have taken up the challenge: P&G, for example, is piloting its own e-commerce site, www.pgestore.com. However, manufacturers must weigh the trade-offs, and for many the economics of launching a branded e-commerce site will prove unfavorable. For those who decide against launching their own Web stores, online retail platforms such as Amazon.com and Alice.com offer direct access to consumers.

5 Forrester Research, *US Online Retail Forecast*, March 2010
6 Mintel International Group, *Online Grocery Retailing – UK*, September 2009
7 ENIGMA GfK's online shopping survey, April 2009

Digital technology will have just as great an impact on brand communication. Consumers are more reliant than ever on referrals: 70 percent look to user reviews to inform their purchase decisions.[8] Moreover, digital marketing is no longer just about one-way communications to consumers. User-generated content can be difficult to control, but it also offers one of the best ways to influence consumer opinion.

In addition, social media provides an important channel for CPG companies to "listen" to consumers without the biases created by conventional research techniques. CPG companies are just starting to tap into social media to understand brand buzz, monitor the impact of campaigns, and even gain input into new product development. For example, Unilever used co-creation with its online community to develop Axe Twist, a fragrance that changes throughout the day. Companies that ignore this important new information source risk being slower to respond and adapt to their consumers' changing needs.

New media requires new capabilities, including rigorous performance tracking, extensive digital-marketing analytics, and flexible vendor management. Winning CPG companies will be those that invest in these capabilities to keep pace with the digital consumer.

The shift to value

The global financial crisis has driven consumers to value offerings, and it is a trend that is likely to stick. Recent McKinsey research suggests that 70 percent of US consumers are looking for ways to save money.[9] Fifteen percent are "trading down" to cheaper brands during the recession, and almost half of consumers say their experience with cheaper brands, including private labels, has exceeded their expectations.[10]

The shift to value has major implications for the CPG industry's profit formula. Not least, it could erode the pricing power of brands. Indeed, our analysis suggests that private-label players are riding the value trend to become a serious force across CPG categories, accounting for more than 40 percent of supermarket sales in the United Kingdom, more than 30 percent in Germany, and more than 15 percent in the United States.

CPG players are employing a variety of strategies to address this trend. Some companies are trying to minimize retailers' need to launch their own private-label brands. For example, a major chocolate company reduced its pack size in the United Kingdom from 150 grams to 125 grams in order to keep the £1 ($1.60) pack price on the shelf, a key concern for retailers. Some companies are rationalizing their price lists to help retailers control SKU proliferation.

8 Survey by Penn Schoen Berland, published in *BusinessWeek*, October 2009
9 McKinsey Consumer Sentiment Survey V, September 2010
10 McKinsey New Normal Survey, March 2010

Other companies are riding the shift to value by running joint promotions with private-label brands in adjacent categories. One major CPG company in the United States is running joint displays and promotions with private-label players; for example, consumers receive a discount if they buy a national brand of cheese along with a private-label bread brand.

Still other CPG companies are meeting the private-label challenge head-on by introducing directly competing lower-priced products and through direct comparisons in advertising that highlight the superiority of their own product. Indeed, the winning companies of the future will be those best able to develop strong value brands with both excellent functional benefits and competitive prices.

The shift to value will make scale an even greater competitive advantage than before. The leading CPG companies have already harnessed their global scale to reduce costs, pushing work to low-cost centers and spreading fixed costs over a broader business. The stronger a company's overall market position and the more number-one category positions it holds, the better equipped it will be to win in a value-focused world.

The impact of demographic shifts on consumption patterns

While consumer markets' center of gravity will shift inexorably toward the developing world over the coming decade, there will also be profound demographic changes across all markets. In particular, the world's population is aging quickly. The United Nations projects that the total population of people older than 65 will double to 1 billion over the next 20 years.[11] By 2030, one in four Western Europeans will be elderly, as will one in five North Americans. But the trend will be just as marked in the developing world: China's over-65 population will double to 16 percent of its total population, while India's will almost double, reaching 8.5 percent.

CPG companies will need to find innovative ways to meet the needs of aging consumers. For example, Unilever's Dove recently launched Pro-Age, a line of deodorants, hair-care products, and skin-care products, to target female consumers between the ages of 54 and 63. In packaged food, ConAgra targets seniors with its Golden Cuisine brand, which offers nutritionally balanced food in packaging that features easy-to-read, large fonts.

While aging represents one major global demographic trend for which CPG companies must prepare, there are others that will be just as important in key markets. In the United States, for example, Hispanics will make up 23 percent of the population in 2030, up from 16 percent today, while the white population will fall from 65 percent to 55 percent.[12] The Census Bureau predicts that the majority of children will be nonwhite by 2023.

11 World Population Prospects, 2008 revision, United Nations (Population Division)
12 US Census Bureau national population projections, 2008

Moreover, despite the global aging trend, pockets of younger consumers are growing in key markets. In sub-Saharan Africa, where many observers expect rapid economic growth in the coming decade, the United Nations predicts the under-50 population will grow 23 percent, reaching about 700 million by 2020.

These micro-demographic shifts create additional opportunities for CPG companies to capture growth. In the United States, for example, many companies are experimenting to capture the growing Hispanic segment. Knowing that heavily-scented products are popular with Hispanics, P&G recently launched Gain laundry detergents in lavender, citrus, and apple-mango scents. And for the first time, P&G used a specialized marketing firm as its lead agency for Spanish-language media. [13]

Increasing supply chain volatility

We have considered four demand-side trends. Just as disruptive, however, will be one trend from the supply side: increasingly volatile input costs, driven by the emergence of bigger, fewer suppliers and natural-resource shortages.

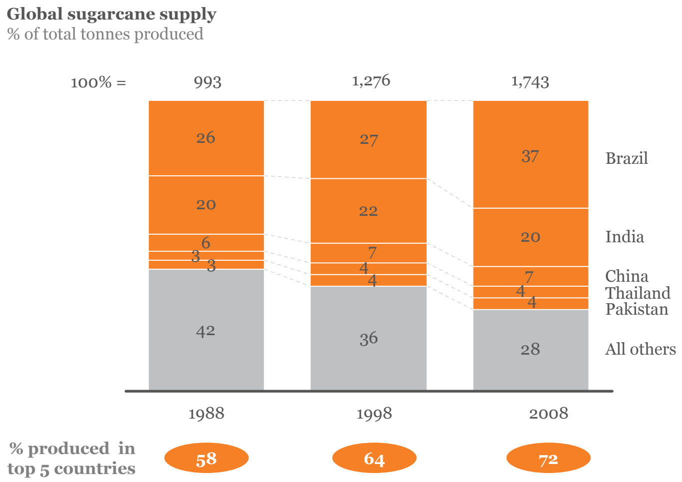
For the most successful CPG companies, globalized trading has represented a huge opportunity to expand into new markets and consolidate supply and production. Yet globalization, combined with specialization, has also triggered a sharp increase in the global volatility of commodity input prices. Global supply chains that have created so much value in the past could be exposed to higher volatility in the future.

The United Nations projects that the total population of people older than 65 will double to 1 billion over the next 20 years.

[13] "P&G taps into popularity of heavier scents," *Financial Times*, October 20, 2010

Exhibit 5 Increasing global concentration of commodity inputs—sugarcane

Million tons



Source: Food and Agriculture Organization of the United Nations (FAOSTAT)

The increasingly concentrated production of several key commodities illustrates this trend. For example, 57 percent of the world's sugarcane is now produced in Brazil and India (Exhibit 5), while China and Russia together account for close to half of the world's aluminum production.

A natural disaster or political crisis in any one of these countries could cause severe disruption to global supply chains. Indeed, the 2010 earthquake in Chile had just this effect on the global pulp market, cutting supply by 8 percent and triggering a spike in prices. Similarly, in late 2009, a fire at one acrylic acid plant in Texas, combined with mechanical issues on one Dow Chemical asset, created a global shortage in superabsorbent polymer, the key ingredient in diapers, feminine-care products, and adult-care products.

Potential natural-resource shortages—notably, ever-increasing stress on the global water supply—further increase volatility. As populations grow and urban areas expand, the United Nations predicts water withdrawals will increase 50 percent by 2025 in developing countries and 18 percent in developed countries.[14] As water shortages affect manufacturing centers for CPG inputs, price increases could spread quickly across the supply chain.

CPG companies face some tough strategic questions as they ponder how best to manage risk in light of this increased volatility—including the price they are willing to pay to secure long-term supply stability, how to reduce commodity and natural-resource inputs across the product line, and how to build flexibility into their supply chains. Navigating exposure to this volatility requires a new paradigm in risk management.

14 UN Environment Programme, *Global Environment Outlook: Environment for Development*, 2007

* * *

In the coming decade, CPG companies will encounter structural shifts from both the demand and supply sides that are likely to be more disruptive than any they have seen in recent history. Is your company ready?

The analytical approach described in this article allows executives to assess the business impact of future trends in a fact-based, quantified way. It also enables them to gauge and protect the value at risk from such trends and to scope the huge value-creation opportunities they represent. In forthcoming articles, we will share our perspectives on how CPG companies can develop the strategies to seize those opportunities.

Ishan Chatterjee is a consultant in the London office. Jörn Küpper and Christian Mariager are directors in the Cologne and New Jersey offices respectively. Patrick Moore is a principal in the Atlanta office, where Steve Reis is a consultant.

Consumer Package Goods Practice
December 2010
Designed by London Graphics, Design & Media

www.mckinsey.com/clientservice/consumerpackagedgoods