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Consumer Packaged Goods Practice

High growth, low profit: The e-commerce dilemma for CPG companies

Online sales of consumer packaged goods have soared during the pandemic. But for many CPG manufacturers, e-commerce means thinner margins. Here's how to change that.

This article is a collaborative effort by Lidiya Chapple, Catherine Fong, Maria Kuska, Megan Lesko Pacchia, Isabella Maluf, and Tatiana Sivaeva, representing views from McKinsey's Consumer Packaged Goods Practice.

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Over the past several months, as many US consumers have spent more time at home—either because of mandated lockdowns or by choice—they've been buying more products online instead of in stores. That's true in most consumer-packaged-goods (CPG) categories, from diapers and shampoo to snacks and beverages. The COVID-19 pandemic has dramatically accelerated the migration to e-commerce—the expected five-year trajectory happened in a matter of months. Whereas only 13 percent of US households had purchased groceries online before the pandemic, 31 percent had done so by late March 2020.[1] Mass retailers' online sales in 2020 were 93 percent higher than they were in 2019.[2]

And the trend shows no signs of fading: McKinsey's consumer-sentiment surveys reveal that US consumers plan to continue spending more of their money online even after the COVID-19 crisis subsides. For example, 43 percent of consumers said they plan to buy at least some of their groceries online postpandemic. Across categories, we're seeing a 20 to 40 percent increase in net intent to shop online post-COVID-19.[3]

This shift in shopping behavior presents something of a predicament for the CPG industry. For many manufacturers, e-commerce has historically been less profitable than brick-and-mortar sales. When we polled US CPG executives during a June 2020 webinar, more than one in four respondents said that low profitability was their number-one concern with regard to e-commerce. Yet e-commerce will almost certainly be one of the primary sources of growth for CPG companies in the foreseeable future. Does that mean margin dilution is inevitable?

We don't believe so. Our research shows that a few CPG companies are beginning to generate healthier margins in e-commerce. Online scale seems to help; companies with large online-sales volumes in a category are more likely to be profitable. But the most crucial success factor is a company's ability to optimize, in a precise and data-driven manner, the three main profit-and-loss (P&L) drivers: marketing investment, costs associated with revenue-growth management (such as trade and promotional spending), and supply-chain costs.

Our research shows that a few CPG companies are beginning to generate healthier margins in e-commerce.

[1] Brick Meets Click/ShopperKit Online Grocery Shopping Survey, March 23–25, 2020, and Brick Meets Click consumer research, August 21–23, 2019.
[2] Affinity credit-card data.
[3] "Survey: US consumer sentiment during the coronavirus crisis," last updated December 8, 2020, McKinsey.com.

Factors affecting e-commerce profitability

As we've studied the effects that the shift toward e-commerce is having on CPG companies' profitability, the following themes have emerged—some surprising, some less so.

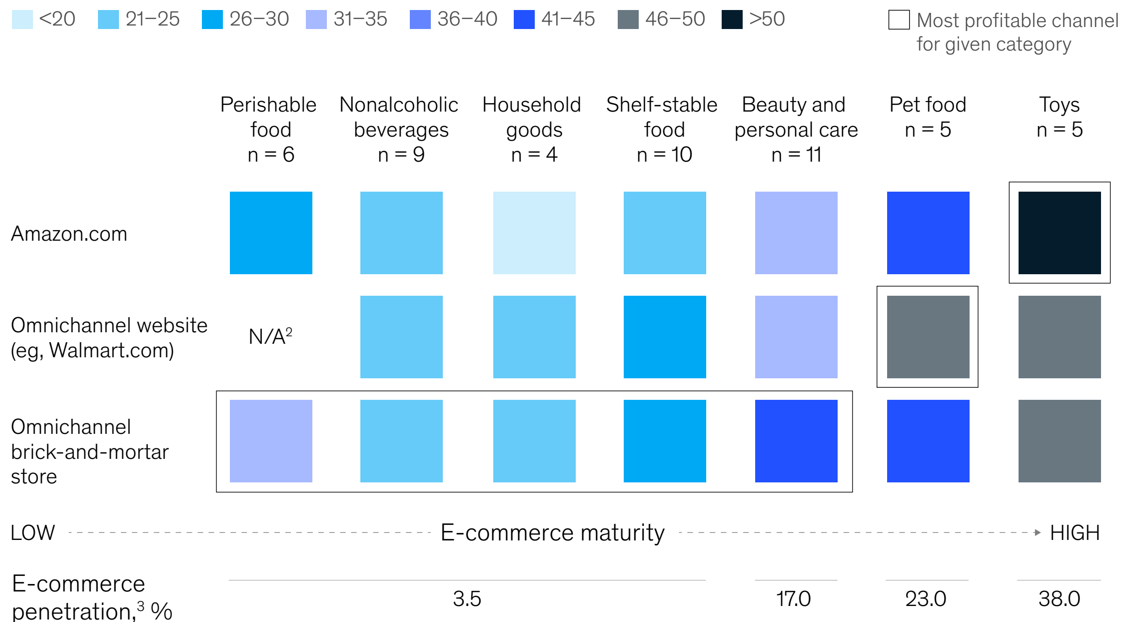
E-commerce margins are slim, at least initially—but scale helps. Some CPG categories are much more profitable online than others. Judging from the results of a July 2020 survey of 50 CPG executives who are decision makers in their companies' e-commerce businesses, a category's e-commerce penetration rate appears to be positively correlated with higher online margins (Exhibit 1). Each retailer's focus and strategy for a given category also have an impact on margins: some mass retailers, for instance, are willing to be loss leaders on key value items. Among online channels, Amazon tends to deliver the lowest margins, but, even there, performance appears to improve with online scale.

Digital advertising and logistics drive e-commerce costs. Promotional allowances tend to be higher offline than online. But other costs—most significantly on-site advertising and logistics—are typically higher in online channels than in brick-

Exhibit 1

Channel profitability varies significantly across categories and is correlated with each category's e-commerce maturity.

Margin,[1] %



[1]Margin calculated as 1 – cost margin; cost margin is sum of returns, promotional allowance, trade merchandising, cost of goods sold, on-site e-retailer advertising, and shipping and warehousing. [2]Responses for "perishable food" are not consistent for omnichannel websites. [3]E-commerce-penetration statistics by Forrester Research, Oct 2019.
Source: McKinsey E-commerce Decision-Maker Survey, July 21–31, 2020 (n = 50)

and-mortar stores (Exhibit 2). On-site advertising, or the ads that appear on retailers' e-commerce platforms, tends to be costly for CPG companies because they invest heavily to ensure prominent placement of their products on the "digital shelf." Shipping and warehousing costs are higher online for several reasons, including the following: choppy ordering patterns (because orders, particularly from Amazon, are algorithmically generated and noncollaborative), which make forecasting more difficult; lower order quantities, which lead to mixed-pallet (versus full-pallet) configurations and less-than-truckload deliveries; higher penalties from online retailers (such as the fines that Amazon charges for poor compliance with its "Ships in Own Container" and "Frustration-Free Packaging" guidelines); and, especially in the food category, the need to reconfigure or repackage certain products to make them suitable for e-commerce. Overall, channel profitability is therefore still highest in brick-and-mortar stores.

CPG executives expect margins to improve. The executives we surveyed expect a modest acceleration in margin growth, from an average of 0.2 percentage points in the past two years to 0.4 percentage points in the next two years—primarily because they expect to both sell higher volumes online *and* get significantly better at e-commerce (for example, by building their price-management capabilities or by improving supply-chain operations so that they avoid incurring retailer penalties). Across online-channel types, the highest expected profitability increase is in omnichannel

Exhibit 2

Advertising and shipping costs are higher in e-commerce, while promotional allowances are higher for brick-and-mortar stores.

Note: Figures may not sum to 100%, because of rounding.
Source: McKinsey E-commerce Decision-Maker Survey, July 21–31, 2020 (n = 50)

retailers' websites (such as Walmart.com or Target.com). Executives are also fairly optimistic about increasing their margins on Amazon—a reversal of the historical trend (Exhibit 3).

Three priority levers for margin improvement

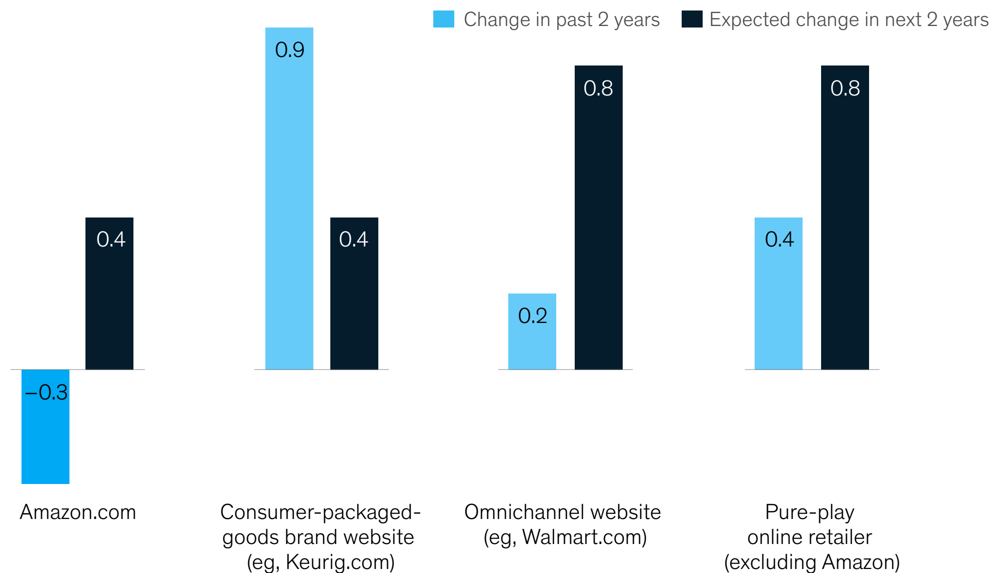
At some CPG companies—especially in less mature online categories, such as food—e-commerce metrics aren't integrated into business reporting, which means it's hard for company leaders to get a full picture of business performance, make informed investment trade-offs, and align decision makers. A crucial first step toward improving e-commerce margins, therefore, is to gain detailed transparency into the e-commerce P&L. One leading CPG company is developing a robust system of e-commerce dashboards and an e-commerce "control tower" (an empowered cross-functional team that reviews real-time data and makes decisions quickly) to give the organization clear, quantitative insights into e-commerce performance.

Companies must then deploy margin-improvement strategies targeted at the biggest cost drivers: marketing investment, e-commerce revenue-growth management (eRGM),[4] and the omnichannel supply chain.

Exhibit 3

Surveyed executives expect pure-play and omnichannel websites to show the greatest margin increase over the next two years.

Change in margins by type of e-commerce channel,[1] percentage points



[1]Question for respondents who reported a change: "If you reported change in margin in last two years, how much did it change? If you expect margin to change in next two years, how much do you expect it to change?"
Source: McKinsey E-commerce Decision-Maker Survey, July 21–31, 2020 (n = 50)

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[4] We define e-commerce revenue-growth management as the discipline of driving sustainable, profitable growth online through a range of strategies involving assortment, promotions, trade investment, and pricing.

1. E-commerce marketing investment

The distinctions between shopper marketing, digital marketing (ads and other promotional material appearing on digital channels), and e-commerce marketing (ads aimed specifically at boosting online sales) aren't always clear, especially when it comes to budget setting and performance management. Historically, CPG companies have drawn largely from their shopper-marketing budgets to fund direct advertising on retail media networks (RMNs) such as Amazon Advertising, Walmart Connect, or Roundel (Target's media company). Yet ad spending on RMNs could justifiably be categorized as e-commerce marketing, given that the spending can be directly linked to higher traffic and conversion on the relevant retailer platform.

Our research and experience suggest that CPG companies spend an average of 7 to 9 percent of gross sales on RMNs—a percentage that appears to be sufficient for maintaining online share. Brands looking to gain share or accelerate growth tend to spend three to five percentage points more on RMNs than the category average annually. And when launching a new brand or SKU, companies spend double or triple the average for a sustained period of time—typically six to 12 months.

Measuring returns on a company's marketing investment gets even more complicated when taking trade and promotions into account. After all, as more eyeballs move out of the store aisle and onto digital channels, an endcap or special in-store display becomes less valuable. As omnichannel shopping continues to grow, CPG companies are starting to think holistically about their e-commerce investments:

— *Funding.* Leading CPG companies are reallocating dollars from brand budgets and pay-to-play trade to pay-for-performance RMNs. Doing so isn't easy, since traditionally these budgets have been managed on different planning timelines and by different parts of the organization. CPG companies will need to reimagine their planning processes—for example, by having cross-functional budgeting and joint performance-management sessions—to generate a clear view of total investment; they'll also need to develop a more agile reallocation mechanism to shift spend quickly as opportunities arise. In addition, leading companies are more closely examining accounting placement: which marketing funds should be allocated to a specific customer versus which should be considered "top of the funnel."

— *Attribution.* Companies must clarify cost-attribution models to ensure apples-to-apples comparisons across channels. Few companies have cracked the code on measuring the omnichannel ROI of their ad spending, but recent advancements in advertising and media platforms, as well as rapidly evolving data and advanced-analytics capabilities (such as ROI modeling), are allowing for improved cross-channel attribution, legitimizing the value of e-commerce investment and facilitating better informed investment trade-offs.

— *Performance management and stakeholder coordination.* Creating a "single source of truth" on omnichannel performance is a priority task for many CPG companies and an important step toward better investment management. Companies looking to improve their margins are also tightening coordination among internal teams, agency partners, and retail partners to enable dynamic investment shifts across marketing tactics and channels. For example, an "always-on" strategy for priority retailers might be sensible but would be inefficient without well-defined budget caps (such as limiting paid-search spending on RMNs to between only the hours of 9:00 a.m. and 5:00 p.m. local time). Executing such changes requires close coordination among multiple stakeholders.

Companies must deploy margin-improvement strategies targeted at the biggest cost drivers: marketing investment, e-commerce revenue-growth management, and the omnichannel supply chain.

2. eRGM

Most CPG companies have already created channel-specific (and, in some cases, even retailer-specific) assortments—bundles, pack sizes, formulation, or packaging—to mitigate channel conflict. Differentiating SKUs across channels and retailers prevents consumers from making direct price comparisons. For example, a pet-food brand sells four-pound and 11-pound bags of dog food on several retailer websites, but its 9.5-pound bags are available only on Target.com.

While unique SKUs can be an effective tactic to decrease price erosion, they are often expensive and drive complexity. To maximize ROI, unique SKUs should at the very least be supported by a consumer-backed rationale (for example, multipacks that appeal to shoppers on stock-up missions). And, of course, cross-functional coordination is critical; lack of such coordination will produce inefficiencies. For instance, launching exclusive SKUs without first aligning with the supply-chain function could increase logistics costs in the channel, or even across channels.

In addition to introducing differentiated SKUs, CPG companies should consider the following eRGM actions to maximize e-commerce margins:

— *Manage to the retailer pricing strategy.* Retailers' pricing strategies vary. While some retailers opt for price congruency (same price online and offline), others take the opposite tack. A retailer might even have a different pricing strategy for each product category. Fulfillment mechanisms matter as well: click-and-collect tends to favor a closed pricing environment in which prices are tailored to ZIP codes, whereas ship-to-home models present higher risks of price-based comparison shopping. Understanding retailers' strategies in the relevant categories will help a CPG manufacturer tailor its pricing and assortments accordingly. For example, a candy company might include smaller pack sizes in its assortment for click-and-collect but not for national ship-to-home.

— *Constantly monitor online prices.* Many CPG companies pay attention to online prices but don't do it systematically. Ongoing, real-time monitoring of prices across channels is vital to ensure that pricing conflicts are detected and addressed early, minimizing downside. A number of providers offer this service today, generally done through web scraping.

- *Develop a retailer segmentation.* Most CPG companies segment their offline retail partners; they should do the same online. Such a segmentation could then inform funding and service levels, which would have an immediate impact on the P&L. CPG manufacturers should prioritize trade spending for their most important retailers, particularly those retailers that offer the most levers to influence performance.

- *Get savvy on new data sources.* Syndicated data sources have long been a staple in CPG performance management. In the online world, however, gathering the right data to conduct revenue-management analyses isn't straight-forward. The market for online data is still highly fragmented, with new types of data, new metrics, and new providers popping up constantly (all with hefty price tags) and no clear winner as of yet. Furthermore, many retailers are reluctant to share their data with new providers; competitive data are also hard to come by. The RGM organization must do the hard work of identifying and vetting the data sources that will help the company most effectively manage gross to net.

3. Omnichannel supply chain

As shown in Exhibit 2, shipping and warehousing costs are significantly higher for CPG companies across all categories when they sell their products on Amazon: 9.3 percent of gross sales, compared with only 7.3 percent for brick-and-mortar stores. The following supply-chain actions would be worth considering to increase online margins overall:

- *Improve demand forecasting and executional precision.* CPG companies should supercharge their demand-planning and inventory-management processes, in part by bringing more and better data into planning systems (including negotiating with retailers to share weekly online sales data) and using more sophisticated algorithms to improve forecast accuracy. Companies should also seek to collaborate with omnichannel retailers to shape ordering patterns and smooth demand, ideally through monthly check-ins with merchants. These actions can result in more on-time deliveries and fewer out-of-stocks, thus reducing the fines CPG companies pay to retailers.

  At the same time, CPG companies should establish a rigorous system for quickly reviewing, categorizing, and then accepting or disputing such fines. A cross-functional team, with representation from manufacturing, logistics, commercial, and finance, should conduct root-cause problem solving as needed and proactively address persistent operational issues. The team should create a data-driven road map for avoiding retailer fines, and prioritize potential supply-chain and operational enhancements by analyzing the costs and benefits of each.

- *Redesign packaging to reduce costs.* Companies can optimize product packaging for e-commerce by, for instance, reducing the packaging's weight, changing its shape to make it more compact, ensuring that it can be easily reused for returns, and, where appropriate, removing unnecessary graphics or content. For example, a leading health-tech company made deliberate choices in its e-commerce packaging: consumers who purchase products online receive them in plain brown boxes without any advertising language, whereas shoppers at brick-and-mortar stores can read about the product's features and benefits on the packaging. (That said, CPG companies should keep in mind that in some categories, such as cosmetics, packaging is part of the "unboxing" experience. Beauty influencers showcase their "hauls" on social media, so the packaging of beauty products—even those purchased online—needs to remain aesthetically appealing.)

- *Rethink delivery pathways.* CPG companies should think through the implications of channel shift on the end-to-end supply-chain infrastructure and planning. For instance, which distribution centers should be used for which

channels and to what extent? Segmenting the warehouses will help optimize deliveries and related costs. One pitfall is overbuilding the network, instead of determining minimum service times and then designing the network based on those. To reduce costs in picking and packing, CPG companies should strive for a healthy balance between lean fundamentals and automation. In addition, given the high e-commerce volumes flowing through third-party order platforms, such as Instacart, CPG companies would do well to find creative ways to cofund delivery through these platforms while also furthering their own strategic goals (for example, building basket size and acquiring new households).

E-commerce doesn't have to be a money loser for CPG manufacturers. But achieving online profitability will require significant mindset changes among CPG leaders: instead of focusing exclusively on top-line growth, they must integrate margin-focused thinking into their strategic and operational planning. And they must embrace a test-and-learn approach, rapidly abandoning failed initiatives and scaling up successes. In light of the dramatic acceleration in e-commerce across categories, there's no time to lose; CPG companies that don't act quickly will soon find themselves unable to catch up.

This article is the first in a series in which we examine the shift to e-commerce in the CPG industry. Watch for follow-up articles on McKinsey.com.

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