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Retail and Consumer Packaged Goods Practices

The next normal in retail: Charting a path forward

To succeed after COVID-19, retailers must assess their revenue management practices, operating models, digital capabilities, capital investments, and M&A strategies—then make bold moves to transform themselves.

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So now what? That's the eminent question US retailers face in the wake of the COVID-19 pandemic. After months of quarantines and phased recovery, it's clear that standard operating procedures in retail have changed and will continue to change as health and economic implications of the novel coronavirus evolve.

Retailers must act now, not only to keep pace but also to thrive in new market conditions. Most will need to significantly rethink their strategies and business models in the next normal—for example, what kinds of goods and services do consumers want and need in this changed environment? What macroeconomic factors will inform their purchasing decisions? Which new consumer habits will stick, and for how long?

Retailers' ability to answer these questions and find success in the next normal will depend, in part, on the subsectors they operate in and their overall liquidity. It will also hinge upon the degree to which they can adopt new capabilities and draw on new expertise—some of which they may need to leverage through mergers, acquisitions, and partnerships.

To begin this transformation process, retailers will need to systematically assess their capabilities in five areas that are critical for any retail operation to succeed: revenue management, operating models, digital, capital investments, and M&A and partnerships. Through this exercise, retailers can identify gaps and requirements and make bold moves to position themselves differently in the next normal.

In this article, we consider how the landscape has changed for three retail subsectors—grocery; apparel, fashion, and luxury (AF&L); and restaurants—as well as the moves companies in these sectors can make to adapt and thrive postpandemic.

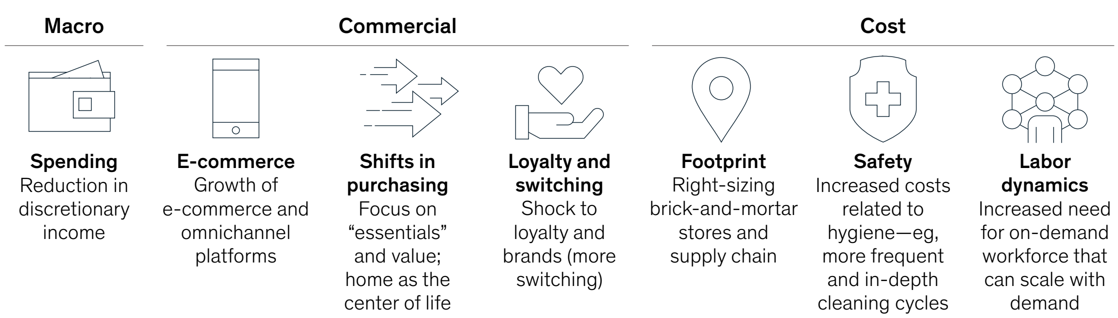
What's changed

According to our "consumer of the future" research, the pandemic has already altered consumer purchasing patterns and behaviors in deep and perhaps lasting ways. Given high unemployment and widespread quarantines, for instance, consumers are at home more often than not. They are shopping less, spending less when they do shop, and focusing more on health and well-being products and concerns.

Significant macroeconomic, commercial, and cost shifts over the past six months or so are changing the landscape for retailers as well (Exhibit 1). Most are anticipating limited containment of the novel coronavirus. Those operating in discretionary categories, in particular, are expecting a slow recovery over the next 18 months or so. And they expect a resurgence of the virus in late 2020 or early 2021, which could mute long-term growth and global recovery.

Exhibit 1

Key shifts in the retail landscape will inform companies' pathways to success in the next normal.



It’s clear that standard operating procedures in retail have changed and will continue to change.

Shifts in spending. Macroeconomic factors during the pandemic period have altered the playing field for retailers. Demand for discretionary products has been significantly different than that for nondiscretionary products. For example, demand in the AF&L sector has dropped significantly, along with demand in the air travel, hospitality, commercial aerospace, and oil and gas sectors. The drop in demand for AF&L products has hovered between 20 percent and 45 percent at various points over the past few months. Overall numbers in the food and restaurant industries are down, although some segments—such as grocery stores and some takeout restaurants—have done well. The demand for groceries, which skyrocketed to between 7 percent and 17 percent as consumers stocked their pantries ahead of and during the pandemic, will likely revert to precrisis levels (between 1 percent and 3 percent) by the first half of 2021. According to our research, sit-down restaurants will likely take much longer to get back to previous norms—perhaps not until 2022 or 2023, depending on which economic scenarios emerge.

Shifts in purchasing, loyalty, and switching. Commercial changes as a result of the pandemic also loom large for retailers. There’s been a significant (if predictable) increase in online sales and pickup and delivery services, as consumers have been unable or unwilling to enter brick-and-mortar stores for fear of infection. Over the past several months, online shopping has increased about 20 percent in the grocery category. As a result, consumer loyalty has been disrupted, and switching has become more common. This is partly because consumers have learned to replace favored brands with more available or more affordable ones in the face of product shortages. More recently, consumers have also shown little compunction when switching to brands they can purchase through contactless or other “safe” methods.

Shifts in footprint, safety, and labor costs. Retailer cost considerations have also changed—among them, greater investments in interventions required to bolster or maintain supply chains, safeguard employees’ and customers’ health, and maintain staffing levels. For instance, as they have started to reopen, restaurants have seen a marked increase in costs because of new cleaning and physical-distancing requirements as well as greater attention being paid to employee safety.

Of the three subsectors we examined, grocery is the most likely to expand both revenues and margins, given its starting point. By contrast, our research shows that AF&L is likely to experience significant revenue decline and margin contraction because of consumers’ reduced discretionary spending and increased use of e-commerce, which tends to be a higher-cost channel for many retailers. And the restaurant sector is likely to see profit-margin pressure—primarily because of higher delivery costs—as well as decreased revenue.

How to transform

Many of the disruptive trends in retail were already in flight before COVID-19 emerged. But in many ways, the pandemic has accelerated these trends from decades to just days. Most retailers likely have not fully planned or addressed all of these trends; thus the capabilities required to transform the business in the next normal will not be first nature to most of them. Most have begun to expand their use of e-commerce, social media marketing, or analytics-based supply-chain management, but hardly any have developed these capabilities to the degree needed to meet current demand.

True transformation and reinvention will come only when senior retail executives take a step back from the turmoil and systematically evaluate their current products, capabilities, and strategies; identify any gaps; and devise a transformation plan (or roadmap) for addressing those gaps. Specifically, retailers should consider their capabilities along the following five dimensions:

Revenue management. Retailers should assess the full suite of revenue levers at their disposal and then double-down on them to sustain and accelerate sales and gross margin. For instance, senior finance and business unit leaders can undertake a clean-sheet evaluation of product assortment, price, and promotion levers to optimize sales and customer loyalty. They can also pursue innovations required to address consumers' changed needs and behaviors as a result of the pandemic. For example, a grocer might consider adding local, organic foods to its product mix—goods that postpandemic consumers may now be willing to pay a premium for.

Operating models. Successful retailers should use this unprecedented period to rethink their operating models—examining store footprints, labor, and supply chains to optimize cost structures and meet changing consumer preferences. Through this analysis, they may identify new sales models or new ways of working that could help alleviate margin pressures. Something as simple as building more flexibility into pickup and delivery operations could help a retailer reallocate resources more effectively and better balance demand loads.

Digital capabilities. Continued physical distancing—mandatory or voluntary—will require that retailers develop or purchase reliable e-commerce or digital capabilities to serve consumers who remain concerned about health and safety in the wake of the pandemic. Retailers may want to establish (or accelerate) expansion into new channels, a curbside pickup option, online-ordering applications, home-delivery options, and other digitally driven services.

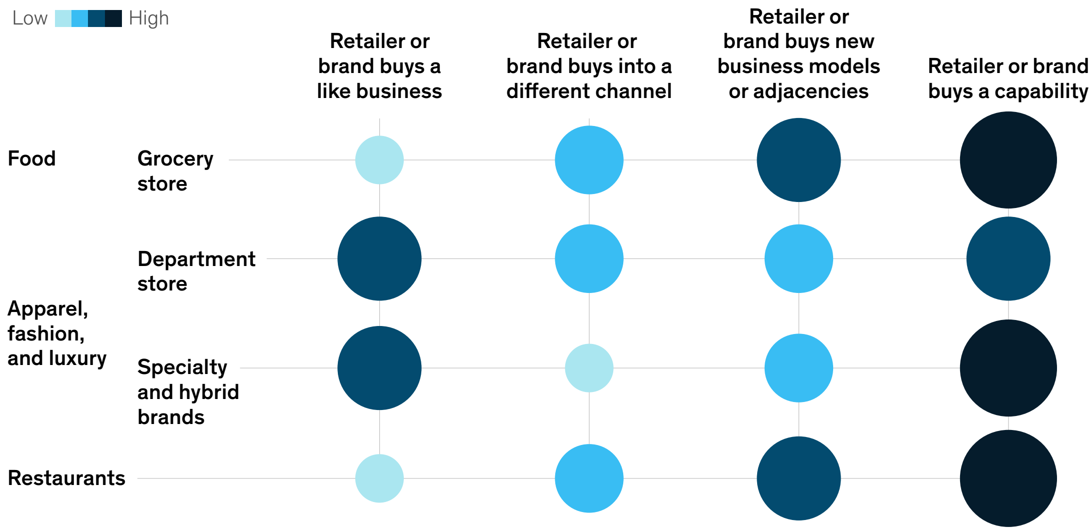
Capital investments. Most retailers understand the critical need to take a closer look at capital investments postpandemic—not only to address consumers' changing preferences, but also to position their organizations for growth in the next normal. With increased investments in technology, for instance, companies may be able to automate and streamline central work processes or otherwise accelerate digital transformation. And companies that are experiencing increased e-commerce demand will likely need to invest in updating their omnichannel networks.

M&A and partnerships. For many retailers, organic moves may be intuitive while inorganic ones, such as M&A and partnerships, may require even more deliberate consideration, especially in this time of great uncertainty. A number of leading indicators suggest that M&A and partnerships hold a lot of promise for retailers in the next normal, as the industry undergoes consolidation and retailers seek new capabilities, technologies, and expertise to address changing customer demands—and do so quickly (Exhibit 2).

Exhibit 2

M&A and partnerships hold promise for retailers in the next normal.

Anticipated relative level of M&A and partnership activity



It's important for retailers to acknowledge that not all deals are created equal; the potential deal must be aligned with the company's overarching strategy. Continued concern over the coronavirus means most grocers will need e-commerce and alternative delivery options, including scan-to-go and contactless payment and pickup services. Thus they may want to seek out deals and partnerships that can provide the necessary technical capabilities (speech-recognition software, for instance) and skill sets (data scientists, for instance); for many, it may simply take too long to acquire the expertise and build the required new systems from scratch. By contrast, retailers with high liquidity may be on the lookout for bargain acquisitions that can help them maintain or even grow revenues—such as seeking out distressed assets or adjacent brands that can help elevate their existing customer-loyalty tactics and programs.

Plan-ahead team. Through a systematic self-assessment, retail executives can pinpoint the organic and inorganic moves to execute that can help them survive and thrive in the next normal. At that point, a plan-ahead team should be convened to prioritize and execute the transformation. These teams identify the actions that can offset long-term headwinds—such as developing new marketing plans to counteract disruptions in brand loyalty or determining what optimal store footprints and shopping experiences should look like in the next normal. The plan-ahead team collaborates with the executive-leadership team to align on the transformation roadmap and to monitor and report back on the results. The plan-ahead team also works closely with the company's finance team to stress-test and update budgets, as initiatives are rolled out, and to assess acquisition targets. Similarly, this team should engage with operations leaders to manage the daily initiatives necessary to drive transformation.

The outlook in three subsectors

Using the self-assessment framework, we can see potential pathways to success in the next normal for companies in the grocery, AF&L, and restaurant subsectors.

The pathway for grocery

Grocery is the subsector of retail most likely to experience revenue growth, as consumers have changed their buying patterns and are cooking more at home. As mentioned earlier, our analysis indicates that topline growth in grocery will continue but eventually stabilize. However, this sector is also likely to face meaningful margin compression because of the limits being placed in the short term by states and municipalities on the number of shoppers allowed in stores, as well as higher costs for cleaning and delivery. McKinsey analyses show that, without transformation, grocers' margins could drop from between 2 percent and 5 percent, on average, before the onset of the pandemic, to between 1 percent and 4 percent going forward.

Continued economic pressure could force grocers to compete on price as they battle for customer loyalty. For this reason, we believe market share could partly shift from supermarkets to lower-cost, more convenient channels, such as mass, clubs, and discounters. The latter are favorably positioned based on footprint, format, and digital strength. Many mass players, for instance, hold sufficient cash as a percentage of sales, indicating that they can make the investments necessary to remain relevant to customers. Clubs are essentially one-stop-shops for consumers and track well against projected reductions in store visits as a result of the pandemic. Retailers that have natural depth and breadth of assortment on their shelves (including unique pack sizes) and in their warehouses are well-positioned in the case of unforeseen supply shocks.

Because of continuing concerns about COVID-19, grocers will need to move even more aggressively into e-commerce and alternative delivery options—including scan-to-go and contactless payment and pickup services. Moreover, consumers' shifting preferences for food items, including those pantry items necessary for routine daily cooking, means that grocery stores will need to continually re-evaluate their full product mix—in many cases shifting to fresh, local, and healthy options in line with consumer trends.

In this environment, grocers may look to reduce costs (between 10 and 15 percent) by accelerating digital and automation transformation across stores and home-office activities; they may be able to achieve this more quickly by seeking out M&A and partnerships that can provide the necessary technical capabilities and skill sets. Partnerships with manufacturers, for instance, may allow grocers to offer private-label and exclusive products at more competitive prices. And tech acquisitions may allow grocers to leverage analytics (and data scientists) that can help them understand and react to shifts in consumer demand and optimize price and promotional investments.

Making bold moves can help retailers build and maintain resiliency.

The pathway for AF&L

The AF&L sector is likely to face a sharp decline in revenue and margins, with a much longer expected time for recovery than other sectors. Extended store closures, lagging consumer sentiment, and financial insecurity are likely to affect the industry significantly over the next few quarters. Gross margins will likely be affected by slower-moving inventory and the need to offer more discounts and promotions to bring consumers back into the fold. Cost of goods sold and selling, general, and administrative expenses may be affected by supply-side constraints, investments in omnichannel sales, and the need to build health and safety infrastructures in physical stores. McKinsey research projects overall revenue losses in this subsector to be from 20 percent to 45 percent in 2020, with the potential for a 30 percent to 55 percent rebound in 2021 (with the possibility of returning to near 2019 levels).

Similar to the grocery subsector, there has been a marked shift in the AF&L sector toward online or omnichannel sales, with a projected postpandemic increase in e-commerce penetration of 10 to 15 percent. Discretionary spending in this category, however, is expected to drop 50 to 60 percent in the next normal. To bolster revenues, AF&L companies may lean even more heavily into omnichannel services—for instance, improving the customer purchasing experience online, enhancing delivery capabilities, or introducing curbside pickup options. They may introduce personalized content—in which consumers can customize colors or designs of certain products—or subscription-based services to try to regain customer loyalty and establish reliable revenue flows. When it comes to inventory forecasting and replenishment, or renegotiating sourcing agreements, AF&L companies may need to rethink their existing strategies—perhaps doubling down on the use of advanced analytics to ensure agility and flexibility as demand rises and falls in the next normal.

To bolster margins, AF&L retailers can renegotiate rents, reduce sourcing and supply expenses, and economize labor forces and store footprints. They can use store and labor data to make strategic decisions about which stores to reopen, the optimal number of in-store versus back-end employees, and the investments required to build out shields, walls, sanitizing stations, and other elements of safety infrastructure.

Those AF&L retailers in a stronger liquidity position may be more aggressive with their M&A programs—for instance, picking up distressed assets, investing in new business models, seeking out possibilities in adjacent markets and channels, or enhancing their brand capabilities through deals. Retailers in this category should focus on elevating customer-loyalty tactics and programs to keep existing customers in the fold and planning new marketing and promotional initiatives to attract new customers during the recovery phase. They may offer special promotions on certain product categories, or apply shopper loyalty points toward services from attractive new partners.

The pathway for restaurants

The frequency of visits to bars and restaurants dropped by 50 percent over the past six months, and our research suggests that restaurants will continue to experience significant headwinds, as consumers choose to stay and eat at home. Continued restrictions will change the way consumers want to be served. There has been and will continue to be a shift to e-commerce, delivery (19 percent increase in consumer adoption of delivery), ordering through online apps, and contactless pickup (21 percent increase in curbside pickup).

Because restaurants have limited real-time labor flexibility, their labor costs will increase as a percentage of revenue as revenues decline. Our research also indicates that margins will decrease by 50 to 100 basis points, given fixed occupancy costs—although relief may be possible if real estate prices go down. Increased costs from new forms of delivery, contactless payment, and a potential shift toward lower-margin products will put added pressure on this segment. Additionally, there will be a continued increase in expenses related to supplies and cleaning.

The restaurants that thrived during quarantines (pizza category), or that were not significantly affected relative to others (burger and chicken categories), are obviously best positioned to rebound. Many have mature technology capabilities and the liquidity to further invest in new capabilities that can improve their operations. Others, however, can accelerate their recovery in the next normal by using a mix of new channels, offerings, and price points. Those with primarily eat-in service, for instance, could expand upon the order-ahead and delivery models they launched during the pandemic. They may use partnerships or M&A to quickly build some of the capabilities required to operate in new ways—such as advanced analytics to increase their forecasting, order-taking, and real-time delivery times.

In the next normal, retailers will need to transform operations and capabilities along several dimensions—bolstering digital and other capabilities, revamping key commercial and revenue growth management levers (price, promotion, assortment), rethinking operating models, and exploring M&A and partnerships. Systematically assessing the company's objectives against the changed landscape and making bold moves can help retailers build and maintain resiliency in the next normal and during other crises that may emerge.

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