McKinsey
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Disruption and uncertainty: The state of grocery retail 2021

North America

Contents

Foreword

COVID-19 hit North America with force in March 2020. As in most other regions of the world, the pandemic has caused an unprecedented health and economic crisis over the past 15 months. Seemingly overnight, grocers became crucial businesses and played a vital role in serving local communities and ensuring an ongoing safe and healthy food supply.

Grocers faced a massive amount of disruption, including unseen demand volatility (for example, ongoing peaks and surges based on community closures and waves of infection), a rapid acceleration of online demand, and a change in typical shopping patterns (such as fewer trips and significantly larger baskets). These patterns resulted from consumers working, eating, and living largely at home. Grocers also had to implement significant changes to their operations to ensure safe work environments.

As vaccine distribution hits key milestones and large portions of North American consumers begin to safely return to their prepandemic habits, we recognize there is significant uncertainty for the grocery industry. All grocers are grappling with a series of questions: Which consumer behaviors observed during the pandemic will stick, and what emerging trends will shape the near term? Will e-commerce continue to grow, and how will grocers improve profitability? How will customers expect to engage with grocers going forward? How much investment will be made in automation? How do we harness technology to change our future? Will there be a flight to value, and what can be done to acknowledge customers' need for affordability? This report aims to answer those questions.

This report is part of McKinsey's broader global series *The State of Grocery Retail*, an annual publication covering three continents (including Asia–Pacific, the European Union, and North America). Our goal is to frame major trends and issues for CEOs seeking to stay ahead of market shifts. To bring a holistic view of industry dynamics, we complemented our colleagues' insights and analyses with surveys and interviews with grocery executives.

We wish to thank FMI for its collaboration in developing these perspectives and supporting the engagement from leading North American grocery CEOs. We hope this report will offer new insights that help grocers remain competitive as they navigate the uncertainty ahead.

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Bill is a partner in McKinsey's Charlotte office and is a leader within the Americas Retail Practice and Consumer Practice. He now leads our North American Grocery practice and has been with McKinsey for the past 11 years. Bill's client work has spanned both retail and CPG sectors with a focus on transformation topics—commercial strategy, organization restructuring, merchandising (pricing, promotion, assortment, vendor negotiations) and operations topics. He has worked across numerous retail channels/formats and consumer categories.

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Acknowledgments

The state of grocery in North America

As the industry looks beyond the pandemic, grocery retailers must determine which trends will endure. A focus on five areas will separate the winners from the rest of the pack.

by Bill Aull, Anuja Desikan Perkins, Sajal Kohli, and Eric Marohn

The COVID-19 pandemic left no industry untouched. Grocers in North America, along with those in other regions of the world, served as essential businesses and critical players in ensuring food supply during a time of great uncertainty. Customer behaviors shifted dramatically and rapidly during the pandemic, forcing grocers to adapt in kind. To prepare for what lies ahead, North American grocers must understand the new industry baseline, the nuances of key consumer shifts observed over the past year, and the behaviors and preferences that will endure once the pandemic abates. Our research suggests the next normal will be shaped by five factors in 2021 and beyond.

The radical shift in grocery-shopper behavior

Grocers gained significant "share of stomach" during the pandemic as consumers across North America shifted to living, working, and learning at home. In an industry that has traditionally seen growth of 1 to 2 percent a year, North American grocery grew by approximately 12 percent in 2020, offsetting significant reductions in food away from home.[1]

The initial disruption of March and April 2020, marked by initial lockdowns and closures of all nonessential businesses, saw consumers choosing to visit grocers outside their traditional primary destinations. This trend, influenced primarily by proximity, store cleanliness, health, safety, and in-stock products, was a notable deviation from historical purchase drivers such as price, service, and in-store experience.

As the world began to see the pandemic as a crisis measured in months, not days, behavior shifts continued to shape an

evolving sector. We have observed several key themes.

A five-year acceleration of online penetration in a matter of months

In late 2019, e-commerce penetration in North America hovered around 4 percent of sales—an important channel for consumers but still niche with certain segments (for example, younger, urban consumers). By late spring in 2020, e-commerce penetration had reached 10 to 15 percent of sales overall, with some regions (such as high-density urban areas) topping 20 percent (Exhibit 1).

Adoption accelerated significantly in demographics not typically considered tech-savvy, such as baby boomers, as they sought fulfillment channels that limited health risk.

This shift in behavior toward e-commerce appears to be quite sticky. Overall, shoppers have been pleased with experiences provided by grocers for both click-and-collect and delivery. Across categories, consumers indicate a continued preference of shopping online, even in traditionally hard-to-crack categories such as fresh meat and produce (an increase of five percentage points in net intent versus prepandemic).[2] Shoppers also indicate that their interactions and experiences with grocers' digital interfaces will meaningfully affect their primary grocery choices in the future: ease of selection and checkout, quick access to past orders and reordering, and transparency into in-stock products will be the most important factors to consumers.

Moving to 'one-stop' shopping

For years prior to the pandemic, grocery shoppers had been increasing both their

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[1] Kantar Retail IQ database.
[2] McKinsey analysis of Brick Meets Click data.

Exhibit 1

Online grocery penetration has risen significantly since the onset of the pandemic.

Estimated e-commerce penetration in grocery, %
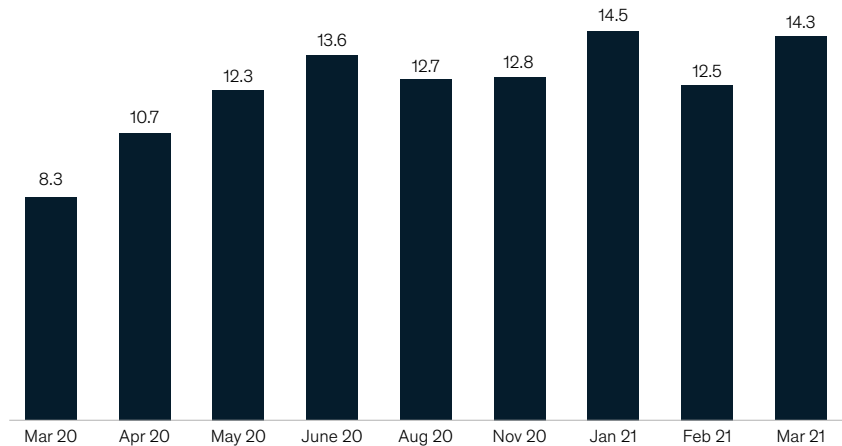
Source: McKinsey analysis (with data from Brick Meets Click)

In the initial stages of the pandemic, grocery shoppers chose where to shop based on in-stock products, store hygiene, and cleanliness procedures.

number of trips per month and the number of grocers they visited. That trend reversed in 2020, with shoppers indicating their overall trip frequency was only half of prepandemic levels through spring and summer of 2020. While trips did begin to increase in late 2020 and into early 2021, our analysis found the number of trips today is only 35 percent of prepandemic levels and unlikely to fully rebound.

As the pandemic continues, shoppers note that the winners of their primary shopping trip tend to offer affordable options and e-commerce capabilities, ensure products are in stock, and offer a robust fresh proposition (Exhibit 2).

Accelerating healthy habits

Throughout the past year, medical professionals have consistently emphasized the increased risk of severe complications from COVID-19 faced by people with underlying health conditions. This awareness has, in turn, sharpened the focus on wellness that was underway prior to the pandemic, creating shifts in category demand within grocery (Exhibit 3).

Furthermore, as consumers look ahead to their food consumption in 2021, they are leaning toward "better for you" options. According to our survey, the net intent to focus on healthy eating and nutrition is expected to be up 38 percentage points

Exhibit 2

Store location will remain relevant in 2021.

Top factor that will influence grocery store selection in 2021 vs 2020, %[1]

Factor	Value
Store location (close to home or work)	21
Competitive prices on branded products	18
Robustness of cleanliness or hygiene practices in store	15
Ongoing availability of fresh food	13
Ongoing availability of value products	11
Availability of e-commerce services	9
Ability to do contactless transactions	7
Ongoing availability of packaged or frozen food	5

[1]Q: Which of the following factors will be more important to you when deciding where to shop in 2021 as compared to 2020?
Note: Figures may not sum to 100%, because of rounding.
Source: McKinsey & Company State of Grocery Consumer Survey 1/13–1/25, n = 4,691 sampled and weighted to match the US general population 18+ years

Exhibit 3

Demand in certain categories, such as fresh and organic products, shifted during the pandemic and look set to endure in 2021.

● Category (Spending preference during or after)

Spending preference in the next 6–12 months vs prior to COVID-19,[1] Net intent[2]

Spend preference during COVID-19 vs prior,[1] Net intent[2]

[1]Q: For items purchased from grocery stores, we want to learn how your spending profile changed during the novel coronavirus outbreak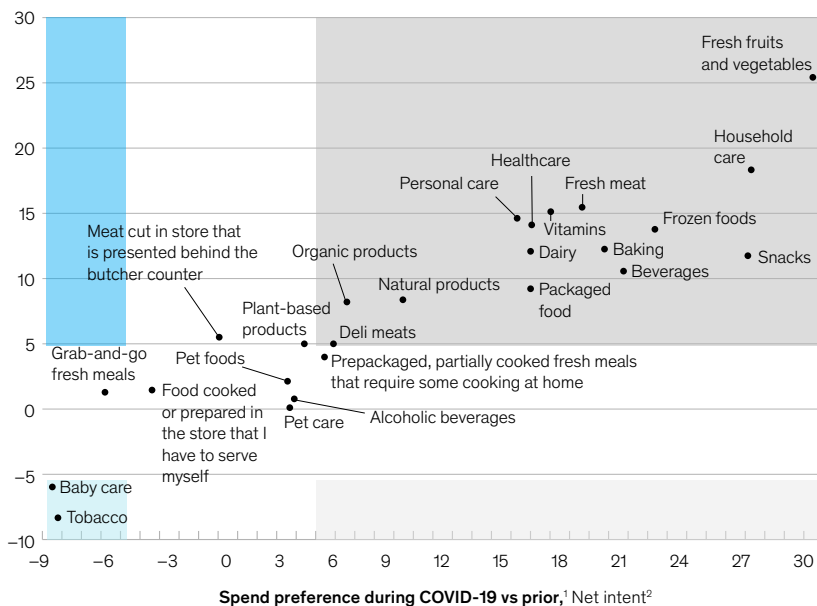, as compared to before the novel coronavirus outbreak. Please indicate how you expect your household's consumption in the following categories to change in the next 6–12 months, as compared to before the novel coronavirus outbreak.
[2]Net intent is calculated by subtracting the percentage of respondents selecting "significantly increase" from the percentage of respondents selecting "significantly decrease."
Source: McKinsey & Company COVID-19: US Grocery Consumer Survey 9/14–9/16, n = 2,010

over 2020, with consumers specifically seeking out naturally healthy, high-protein, low-sugar, and low-calorie foods.

Increasing focus on affordability
In the initial stages of the pandemic, grocery shoppers chose where to shop based on in-stock products, store hygiene, and cleanliness procedures. As 2020 progressed, however, affordability began to climb the ranks in importance, and 2021 is poised to see consumers demonstrate even more bargain-hunting behavior:

when choosing where to shop, 45 percent of consumers indicate they plan to look for ways to save money, and 32 percent of consumers will seek a price–quality balance in product offerings (Exhibit 4). The emphasis on affordability will also likely serve as an accelerant for private label. The past year saw remarkable growth for leading private-label offerings in grocery. In 2020, for example, private-label sales rose by more than 13 percent at Albertsons and Kroger. This trajectory

Exhibit 4

Consumers will increasingly look for ways to save money and focus on healthy eating and nutrition in 2021, while still favoring stores that balance price and quality.

Consumers plan to continue purchasing private labels, mainly because they offer equal quality for less money.

Grocery shopping attitudes in 2021 vs 2020, %[1]

Net intent,[2] %

■ Increase   ■ Stay the same   ■ Decrease

Statement	Increase	Stay the same	Decrease	Net intent
Look for ways to save money when shopping	45	53	2	+42
Switch to less expensive products to save money	29	63	8	+21
Actively research for best promotions	30	63	7	+23
Buy private-label products instead of known brands	20	71	9	+11
Buy imported products	8	62	30	−22
Buy food from fresh bars and deli counters in stores	18	64	18	0
Focus on healthy eating and nutrition	42	55	3	+38
Interact with store employees at check-out vs. self checkout	15	64	21	−6
Buy groceries in large stores, where I can buy everything in one place	27	67	6	+21
Buy groceries online	20	54	26	−7

Top reason for buying more private-label products, %[3]

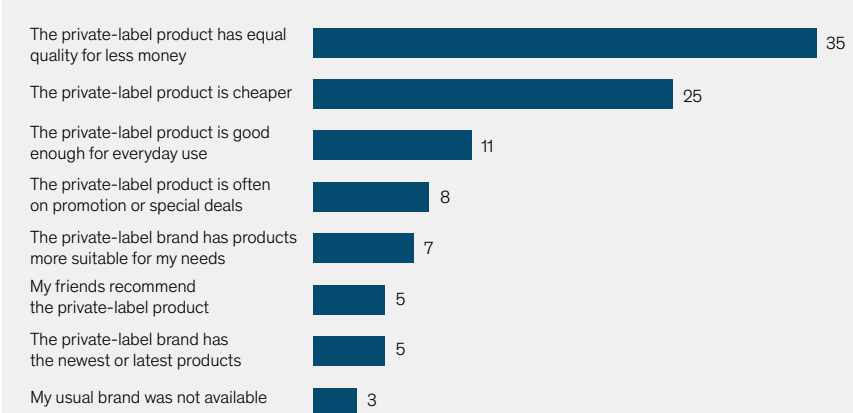| Reason	%
The private-label product has equal quality for less money	35
The private-label product is cheaper	25
The private-label product is good enough for everyday use	11
The private-label product is often on promotion or special deals	8
The private-label brand has products more suitable for my needs	7
My friends recommend the private-label product	5
The private-label brand has the newest or latest products	5
My usual brand was not available	3

[1]Question: Which of the following statements best describes your attitudes toward grocery shopping in 2021 as compared to 2020? You indicated that you plan to purchase more private-label products (eg, store brand products) in 2021 relative to 2020. Which of the following reasons best describes why?
[2]Net intent is calculated by subtracting the percent of respondents stating decrease from the percent of respondents stating increase.
[3]Figures may not sum to 100%, because of rounding.
Source: McKinsey & Company State of Grocery Consumer Survey 1/13-1/25 n = 4,691 sampled and weighted to match the US general population 18+ years

could continue as consumers see better value in private-label products.

Growing expectation of personalization as the norm
Personalization in retail has gained massive traction over the past five years, evolving from a predominantly mass promotion–based approach to segmented, customized, and real-time dynamic offers. Although the definition of personalization can be broad, consumers tend to reward retailers that combine great timing, relevant offers, and attractive pricing. This trend toward personalization is evident in the investments retailers are making. Indeed, 60 percent of leading grocery retailers indicated they had made investments in 2020 to enhance capabilities to better personalize pr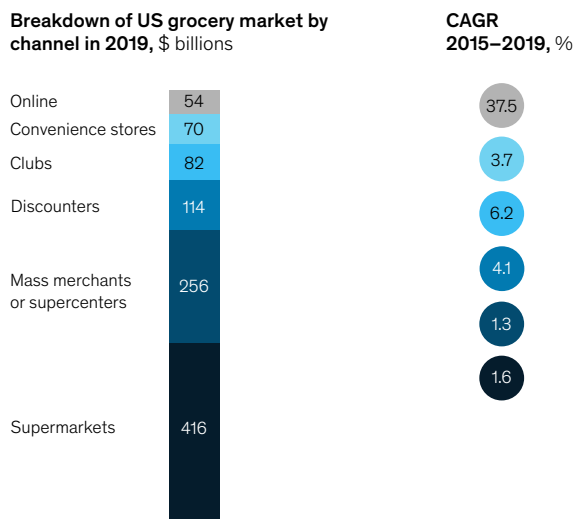omotions and pricing. In the battle to retain market share, personalization and its delivery will likely continue to rise in importance.

How the pandemic reset the playing field for winners and the rest of the pack
From 2010 to 2020, North American grocers followed a path similar to that of their counterparts in other geographies. Deep discounters had entered the market and were gaining share aggressively over mass players, supermarkets, and even club players. From 2015 to 2019, discounters grew at an impressive 6.2 percent, far outpacing the growth of other grocery formats, and further national expansion plans are imminent (Exhibit 5). To defend against this threat, mass players and large national supermarkets responded with

Exhibit 5

Supermarkets and supercenters are losing share in grocery retailing to discounters, convenience stores, and e-commerce.

Breakdown of US grocery market by channel in 2019, $ billions

CAGR 2015–2019, %

Channel	$ billions	CAGR %
Online	54	37.5
Convenience stores	70	3.7
Clubs	82	6.2
Discounters	114	4.1
Mass merchants or supercenters	256	1.3
Supermarkets	416	1.6

Source: Kantar Retail IQ

strategies ranging from significant national price drops to store remodels and supply-chain investments. All of these moves came at the expense of smaller, more regional chains. Furthermore, nearly 2,300 grocery retailers closed from 2012 to 2019. The outlook for subscale supermarkets without a differentiated value proposition versus larger mass players or national supermarkets was bleak: in the absence of a defendable value proposition, they were left to compete on price, racing to the bottom with discounters without seeing returns in traffic.

In a reversal from prepandemic trends, supermarkets and mass players benefited from the trends of the past year. Their seemingly endless aisles with a large SKU assortment provided consumers with options when items were out of stock. Their investments in fresh foods were a welcome tailwind as consumers increasingly sought to eat healthier foods. Furthermore, their local store density and historical community roots provided consumers with a sense of trust and confidence in shopping. And several supermarket chains rose to the e-commerce challenge by quickly bolting on click-and-collect or delivery services through third-party providers. Without having to compete primarily on price, the core proposition of supermarkets was once again attractive. Prominent supermarkets reported sales growth of anywhere from 12 to 16 percent in 2020, beating out several club and discount players alike. With consumers indicating that selected pandemic-induced behaviors will remain sticky, the landscape might continue to evolve.

Considerations for the next normal

As North American consumers begin to adjust to the next normal, we anticipate that the landscape of winners and losers in grocery will cease to be determined by format. Instead, leaders will be defined by their differentiation, innovation, and defensibility across five main areas. (For the CEO perspective, see sidebar, "The view from the C-suite.")

1. *Winning higher share of stomach.* Before the pandemic, consumers typically split their share of stomach across more than three grocers. Most consumers had their go-to stores for fresh, center-store, and stock-up products and were willing to add the additional weekly or biweekly trip to fulfill each need. In light of the pandemic, we have observed an undeniable consolidation of trips, and consumer sentiment shows no signs of changing: 88 percent of consumers visited three or fewer stores per week in 2020, and 86 percent of consumers plan to continue this trend in 2021. Forty percent of consumers indicate that they would prefer to frequent stores that sell more than just groceries. And the undeniable success of mass players in 2020 further points to improved consumer sentiment around trip consolidation. This will likely place some pressure on grocers with specialty and niche value propositions—the bar to deliver exceptional products, value, experience, and service will be higher to justify an additional trip. Clarity in what these grocers stand for and flawless execution will be key to retaining share of stomach.

The view from the C-suite

In partnership with FMI, McKinsey surveyed North American grocery CEOs to gather insights on their learnings from the past year and their perceptions of the key focus areas for the industry (and their company) through 2022. Reflecting on 2020, CEOs noted four major themes that shaped the year: safety and regulations, supply chain, e-commerce, and organizational decision making.

After proving their resilience during the pandemic, grocery leaders are now focusing their attention on the next normal. CEOs recognize that some of the shifts during the pandemic will endure through 2021 and 2022. Our survey analysis highlighted three key trends that leaders consistently highlight as most likely to shape the years ahead: the rapid acceleration of digital, shifting consumer preferences, and a greater emphasis on affordability.

More insights from North American grocery CEOs are featured in the upcoming *State of Grocery Retail North America* report.

2. *Credibly competing in the omnichannel battleground.* Before the pandemic, select retailers whose brick-and-mortar stores provided a competitive advantage through differentiated in-store experiences, services, locations, and formats, among other attributes, considered an omnichannel presence a "nice to have" feature. Now, to compete in today's environment, in which recent McKinsey research finds 52 percent of households shop for groceries online across a spectrum of occasions (top-up, fill-in, full shop), an omnichannel presence is an imperative. Grocers will need to dissect their internal e-commerce operations or third-party models to meet growing consumer expectations for experience (such as site usability, transparency into in-stock products, and better-picked fresh produce), all while ensuring that the channel increases margins, particularly when it is on pace to account for upward of 20 percent of the overall business.

3. *Elevating pricing and value.* While store cleanliness practices and product availability dictated where consumers chose to shop in 2020, convenience and value will carry the day in 2021. An estimated 32 percent of consumers indicated that a healthy price–quality equation will dictate where they choose to shop in 2021, and 45 percent of consumers will look for ways to save money. The increased momentum in private label further supports consumers' renewed focus on value. Grocers will need to carefully consider how to invest in pricing and promotions—2020 saw a reduced period of promotional activity owing to the surge in grocery demand, but we

anticipate a return to more strategic pricing and promotional activity in 2021.

4. *Renewing the focus on fresh, new, and innovative.* During 2020, a sense of nostalgia made consumers turn to products from their childhood, particularly in the center of the store, and we observed a reduction in the typical innovation-charged new-product releases. However, as fatigue sets in around cooking at home, we expect consumers to demand more innovation across fresh, ready-to-eat, and frozen products. In our sample, 39 percent of consumers want grocers to introduce them to innovative products and experiences, 41 percent want to eat better, and 42 percent plan to continue to cook meals from scratch at home in 2021. These preferences all point to the need for grocers to have a strong fresh program and an assortment across departments that delivers on both better-for-you and new and exciting consumer needs.

5. *Accelerating personalization.* While affordability perception continues to be a primary driver of store selection, personalization is growing in importance. Consumers are looking for simplicity, a sense that the offers and messages are tailored to them, continued innovation in offers, responsiveness to consumer behavior versus a preset calendar, and seamless integration of a retailer's different programs. Consumers want to feel recognized as individuals by grocers, which will have to engage beyond relying on mass promotional activity as the answer to share retention. To meet these expectations, grocers will need to rally their organizations around a strategy and vision for personalization; clearly define an operating model between merchandising, pricing, and loyalty teams; and invest in the technology to support the personalization vision.

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The past year presented one of the most challenging for society at large and produced what will likely be enduring consumer behaviors in grocery. The grocery sector demonstrated an incredible amount of resiliency in 2020 and is poised to continue to serve the most urgent consumer needs, albeit against a drastically different set of imperatives from two years ago.

Making online grocery a winning proposition

The global pandemic brought online platforms to center stage for grocers. Retailers should consider five trends and take five steps to ensure this shift is sustainable and profitable.

by Bill Aull, Steven Begley, Vishwa Chandra, and Varun Mathur

Prior to the COVID-19 pandemic, the US grocery sector was lagging other retail sectors in e-commerce adoption. Customer reservations about buying fresh food online, along with high e-commerce fees and nonintuitive website designs, stunted adoption. The grocery sector's penetration was 3 to 4 percent and significantly trailed sectors such as beauty, apparel, and electronics, all of which had penetration rates of 10 to 20 percent or more.

But the pandemic changed that trajectory. During the peak of the pandemic, grocers watched 20 to 30 percent of their business shift to online, driven by a sudden surge in demand for contactless shopping. By the end of 2020, online penetration in grocery had settled at 9 to 12 percent—a threefold increase from prepandemic levels and in line with mature markets such as France and the United Kingdom. This disruptive shift happened at breakneck speed; in a matter of months, the grocery e-commerce landscape in North America accelerated by three to

five years. The e-grocery penetration in the US market is projected to get to 14 to 18 percent, or more, in the next three to five years. Here's what we see as the new bellwethers for the next few years.

Five consumer trends shaping grocery e-commerce

Consumer preferences have changed across the board—from how and what consumers buy to their expectations for customer experience and pricing.

1. *Increased online shopping is here to stay.* Despite recent increases in brick-and-mortar traffic as consumers start reverting to their shopping norms, nearly 50 percent of consumers we surveyed indicated that they buy groceries online at least once a week, representing a "next normal" (Exhibit 1). Most consumers are using e-commerce as a way to stock up or top off their weekly and monthly grocery needs, in addition to visiting a physical store. More than half of these consumers spend more than $100 per online-grocery transaction.

Consumer preferences have changed across the board—from how and what consumers buy to their expectations for customer experience and pricing.
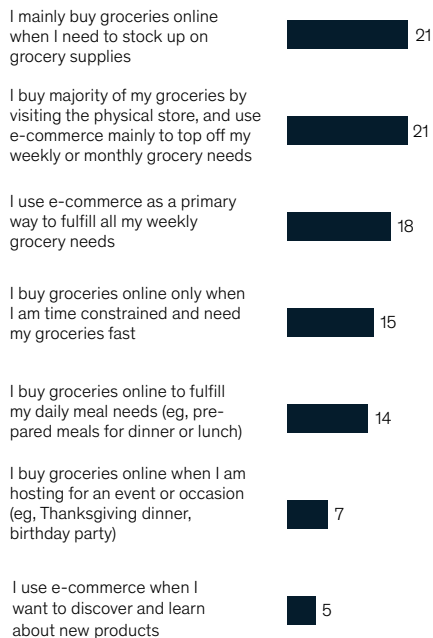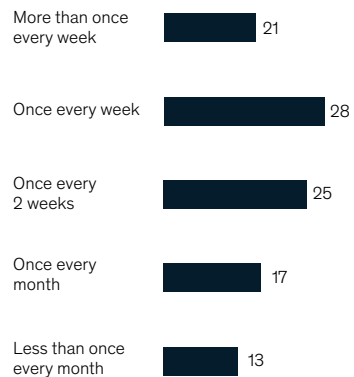
Exhibit 1

Consumers are using e-commerce for stock-ups, top-offs, and primary grocery purchases.

Main occasion for ordering groceries online,[1] %

I mainly buy groceries online when I need to stock up on grocery supplies	21
I buy majority of my groceries by visiting the physical store, and use e-commerce mainly to top off my weekly or monthly grocery needs	21
I use e-commerce as a primary way to fulfill all my weekly grocery needs	18
I buy groceries online only when I am time constrained and need my groceries fast	15
I buy groceries online to fulfill my daily meal needs (eg, pre-pared meals for dinner or lunch)	14
I buy groceries online when I am hosting for an event or occasion (eg, Thanksgiving dinner, birthday party)	7
I use e-commerce when I want to discover and learn about new products	5

Frequency of online grocery purchases,[2] %

More than once every week	21
Once every week	28
Once every 2 weeks	25
Once every month	17
Less than once every month	13

[1]Q: What occasions do you use for ordering groceries using online interface (website or app)? Please rank top 3 occasions.
[2]Q: How frequently do you purchase groceries online (website or app)?
Source: McKinsey & Company COVID-19: US Online Grocery Consumer Survey 12/10-12/17 N=2,007

2. *Fresh and frozen categories have gained the most traction in online demand.* All grocery categories experienced a significant increase in e-commerce adoption over the past 12 months, with shelf-stable categories such as household care, snacks, personal care, and packaged foods leading the basket mix in e-commerce. But categories that traditionally had lower representation online, including dairy, produce, fresh meat, and frozen food, also saw a significant increase in consumer willingness to buy online (Exhibit 2). What's more, these preferences are showing stickiness beyond 2020 because of the convenience associated with buying online. This trend is similar to what we're seeing in other parts of the world; in China, for instance, 55 percent of consumers said their preference is to continue buying more groceries online after the pandemic.

3. *E-commerce modality is shifting.* The US online grocery market is evolving to a mix of instant, or same-day, delivery and click and collect. This composition is significantly different from those of

Exhibit 2

Consumers prefer using e-commerce for every grocery category overall, but their preference for e-commerce has decreased for most categories since the height of the pandemic.

Consumers' intent to use e-commerce by category in the next 6 months,[1] %

■ Increase ■ Stay the same ■ Decrease

	e-commerce preference	Change vs Sept survey	Change vs before COVID-19	Change vs during COVID-19
Household care	83	0	+10	−2
Snacks	82	0	+10	0
Personal care	82	−2	+9	−1
Packaged food	81	−1	+7	+1
Beverages	79	−1	+8	+1
Healthcare	75	−2	+10	+2
Frozen foods	74	−2	+10	+2
Dairy	72	−4	+10	+1
Fresh fruits and vegetables	72	−3	+5	+5
Fresh meats	67	+1	+13	−2
Natural products	65	+1	+11	−4
Deli meats	65	+1	+11	+1
Pet care	60	+2	+10	−5
Organic products	59	+3	+9	−5
Plant-based proteins	53	−1	+12	−1
Food prepared in store	53	+2	+11	−3
Alcoholic beverages	51	−2	+11	−4
Baby care	40	0	12	−3

[1]Q: Please select your preference to use e-commerce to purchase the following categories BEFORE/DURING the coronavirus outbreak and in the next 6 months.
Source: McKinsey & Company COVID-19: US Online Grocery Consumer Survey 12/10–12/17, n = 2,007; 9/18–9/23, n = 1,014

In the United States, grocery-delivery services providing contactless shopping experiences accelerated a market shift toward same-day delivery.

more mature international markets; historically, France has been primarily a click-and-collect market (90 percent of total grocery e-commerce), while the UK market has been mainly next-day delivery (80 percent of total grocery e-commerce). In the United States, grocery-delivery services providing contactless shopping experiences accelerated a market shift toward same-day delivery, allowing more grocers to partner with third-party providers such as Instacart to quickly build their e-commerce value proposition. Moreover, food-delivery platforms such as DoorDash and Uber Eats have entered grocery delivery, and Amazon continues to drive momentum with Amazon Fresh.

In addition to its impact on delivery, the pandemic also accelerated consumer adoption of buying online and picking up curbside or in-store, with click

and collect experiencing the highest increase in consumer intent to use these services, both in 2020 and beyond (Exhibit 3). Lower service fees, greater availability of time slots, and the convenience of picking up while on the road are key factors driving the increased adoption of click and collect. Grocers are also shaping this trend by investing in infrastructure to quickly build click-and-collect capabilities across their network so that they can offer a stronger customer experience. This shift will be very meaningful for grocers because click and collect offers significantly better economics compared with delivery services.

4. *'Clunky and scrappy' user experience is not an option.* Consumers have more choices than ever before in where to shop online. While brand strength and quality continue to be important, the user experience in the e-commerce

Exhibit 3

Since the onset of the COVID-19 pandemic, consumers have shifted spending toward buying online and picking up curbside or in-store.
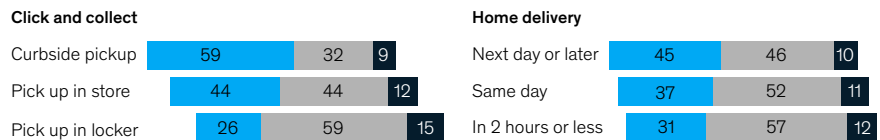
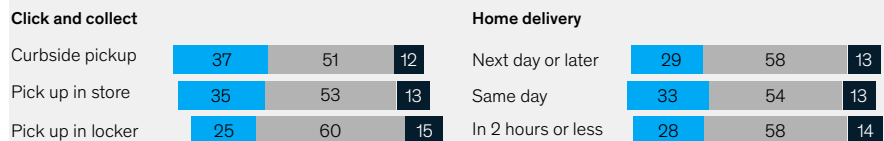**Top factors for preferring click and collect or home delivery,** %

■ Sept 18–23, 2020 ■ Dec 12–17, 2020

Click and collect[1]

Less expensive service fees	25
	22
Faster access to groceries	17
	17
More convenient	15
	15

Home delivery[2]

More convenient	47
	47
Flexibility, no need to be present	18
	16
Faster order fulfillment	12
	12
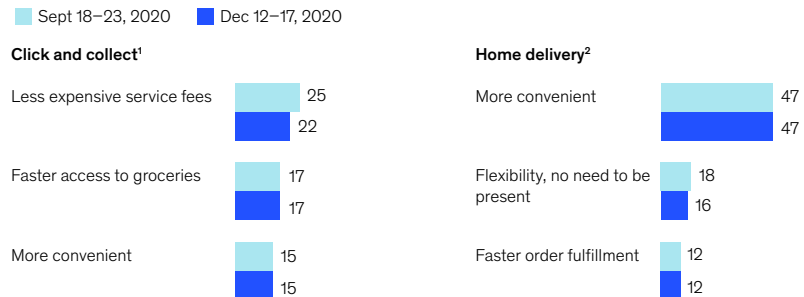
Spending preferences per category,[3] %

■ Increase ■ Stay the same ■ Decrease

During COVID-19 situation vs before[4]

Click and collect

	Increase	Stay the same	Decrease
Curbside pickup	59	32	9
Pick up in store	44	44	12
Pick up in locker	26	59	15

Home delivery

	Increase	Stay the same	Decrease
Next day or later	45	46	10
Same day	37	52	11
In 2 hours or less	31	57	12

Expectation for next 6 months vs past 6 months[5]

Click and collect

	Increase	Stay the same	Decrease
Curbside pickup	37	51	12
Pick up in store	35	53	13
Pick up in locker	25	60	15

Home delivery

	Increase	Stay the same	Decrease
Next day or later	29	58	13
Same day	33	54	13
In 2 hours or less	28	58	14

[1]Q: Why do you prefer using click and collect instead of delivery service?
[2]Q: Why do you prefer using home delivery instead of click and collect?
[3]Figures may not sum to 100%, because of rounding.
[4]Q: How has your spend on grocery e-commerce changed DURING the coronavirus outbreak (last 6 months) vs before the outbreak?
[5]Q: How do you expect your spend on grocery e-commerce to change in the next 6 months vs the last 6 months?
Source: : McKinsey & Company COVID-19: US Online Grocery Consumer Survey 12/10-12/17, n = 2,007; 9/18–9/23, n = 1,014

journey is becoming increasingly relevant for consumers in deciding where to shop—a crucial point for traditional grocers to consider as they enhance their online offerings. Ease of use (for example, product selection, saved preferences, and order history for reordering) and self-serve access to information (such as stockouts, progress updates, and changes to orders) are the most important drivers of consumers' online journeys (Exhibit 4).

Exhibit 4

Quick selection and checkout as well as easy access and reordering of past purchases are the most important features in online interfaces.

Importance of online interface features,[1] %

■ Least important feature ■ Most important feature

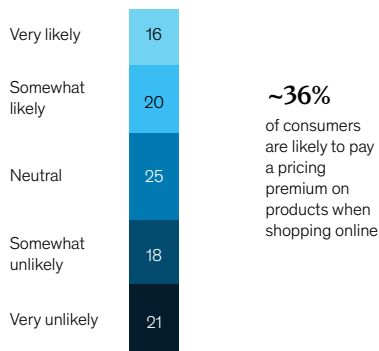| Feature	Least	Most
Quick selection and checkout (with few clicks)	7	15
Easy access and reordering of past purchases	8	15
Accurate information on out-of-stock items	7	14
Ability to track progress of my order	7	13
Ability to make changes before/during picking	7	11
Ability to create customized lists and preferences	9	8
Display of promotions to help guide product selection	10	8
Useful product recommendations based on past purchases and items in current order	12	5
Chat feature with order picker	16	5
Other household members have ability to access and edit orders	17	4

Note: Figures may not sum to 100%, because of rounding.
[1]Q: Which features of the online interface (website or app) are most important to you?
Source: McKinsey & Company COVID-19: US Online Grocery Consumer Survey 12/10–12/17, n = 2,007
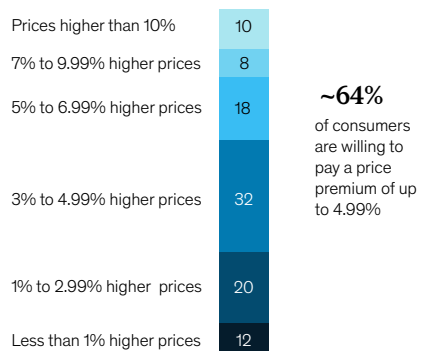
Exhibit 5

Only about 36 percent of consumers are likely to pay a price premium when shopping online, and two-thirds of this group would only pay a premium of less than 5 percent.

Likeliness to pay a pricing premium on products when shopping online,[1] % of respondents

Very likely	16
Somewhat likely	20
Neutral	25
Somewhat unlikely	18
Very unlikely	21

~36% of consumers are likely to pay a pricing premium on products when shopping online

Willingness to pay price premium on groceries bought online vs prices in store,[2]
% of respondents

Prices higher than 10%	10
7% to 9.99% higher prices	8
5% to 6.99% higher prices	18
3% to 4.99% higher prices	32
1% to 2.99% higher prices	20
Less than 1% higher prices	12

~64% of consumers are willing to pay a price premium of up to 4.99%

[1]Q: How likely are you to pay a premium price on products (vs prices in store) when buying groceries online?
[2]Q: What will be your willingness to pay price premium on groceries bought online vs prices in store (excl delivery fee, personal shopper fee for curbside, tips, etc)?
Source: McKinsey & Company COVID-19: US Online Grocery Consumer Survey 12/10–12/17, n = 2,007

5. *Customers are willing to pay for convenience—to an extent.* During the COVID-19 pandemic, many grocers have responded to the crisis by promising lower service fees and "same as in-store pricing" for e-commerce. However, because of picking and delivery operations, grocers face a significantly higher cost to serve for e-commerce than for brick-and-mortar operations. As we shift toward the next normal, e-commerce service fees and pricing could push upward. However, only 36 percent of consumers indicated a willingness to pay a price premium when buying groceries online, and two-thirds would pay a premium only if it were less than 5 percent (Exhibit 5). This sentiment limits the ability of grocers to pass higher e-commerce operational costs on to customers through pricing. Grocers will need to find ways to make the value proposition profitable through other levers, such as increased basket size and operational efficiencies.

Five ways to tackle profitability

These macroshifts fundamentally changed the way consumers think about purchasing groceries, forcing grocers to quickly scale their e-commerce offerings. Now, grocers are pivoting to making e-commerce both sustainable and profitable. As e-commerce becomes a more significant portion of grocers' ongoing business, grocers must scale e-commerce in a way that drives total shareholder value. Different players are pursuing different strategies to achieve both growth and higher profitability—or at least profit parity. At the same time, several common themes emerge in the way grocers are solving the profitability puzzle, both in the United States and globally:

1. *Aggressively capture online share through a distinctive value proposition and user experience.* With the ecosystem of brick-and-mortar grocers at different levels of e-commerce maturity—and with pure players such as Amazon and third-party providers like Instacart playing in the space as well—offline share is not an indicator of "fair share" of the online market. Outside the United States, retailers such as Tesco in the United Kingdom have been able to gain a higher share of online market versus their brick-and-mortar share because of a compelling value proposition, powered by timely investments in technology and operations. Grocers that create a distinctive value proposition balancing total cost to customer (including premium pricing, delivery and service fees, and tips) with relevant product assortment and an intuitive user experience are better positioned to increase online traffic and build bigger baskets. The value proposition needs to be clearly defined across modalities (instant, same day, next day, click and collect) and in the context of the macroshift toward instant and same-day e-commerce.

2. *Focus on the omnichannel value of customers.* The economics of e-commerce will continue to be challenging compared with that of brick-and-mortar stores. However, grocers that can build loyalty, personalize offers, and create incentives for customers to visit brick-and-mortar stores while also increasing their frequency and basket size of online purchases stand to gain

a significant advantage. Grocers are also starting to test in-store programs and promotions to bring consumers into their online ecosystem. Even though e-commerce presents a risk of cannibalization to brick-and-mortar business, winning grocers have been able to increase their total share of wallet with existing customers by 20 to 30 percent through an omnichannel strategy.

3. *Monetize digital assets.* As they have done for in-store assets via endcaps, off-shelf placements, and more, grocers are looking to monetize their digital assets by exploring new avenues to partner with consumer-packaged-goods (CPG) companies. At the same time, CPG companies are looking to invest disproportionately in digital (about 1 to 5 percent of sales) to fuel growth. This dynamic creates an opportunity for grocers to unlock new sources of revenue from CPG companies that want to secure digital space for promotions, preferential product placement on UX design, and media placement, as well as to explore data-sharing endeavors.

4. *Reimagine e-commerce ecosystems and partnerships.* Several incumbents have chosen partnerships with leading ecosystems such as Amazon and Instacart to create an online route to market or provide a specific proposition. These partnerships bring scale, infrastructure, and capabilities that grocers would otherwise need years to build. However, many grocers are rethinking partnership structures to get closer to the customer and capture operational efficiencies. Strategies include renegotiating terms with third-party providers to increase access to customer data and exploring "white-label" platforms. Innovation in these partnership models will be critical to strike the right balance between serving the current needs of customers and future-proofing longer-term growth and economics.

5. *Innovate in fulfillment operations.* Grocers need to optimize the mix of third-party and in-house fulfillment capabilities to create the right infrastructure to deliver on the customer promise while being cost effective and agile. For in-house fulfillment operations, the right technology will be vital to support future growth. For example, many grocers are moving toward micro-fulfillment centers to add e-commerce pick capacity in their existing spaces without creating large, automated

Many grocers are rethinking partnership structures to get closer to the customer and capture operational efficiencies.

warehouses that are capital intensive. Similarly, for delivery operations, grocers are increasingly testing gig platforms and outsourced-driver models to cater to instant and same-day e-commerce demand.

To win online, grocers need to rethink their e-commerce operating models. Unlike before the pandemic, when e-commerce accounted for 3 to 4 percent of total sales, e-commerce now requires renewed organizational focus and diligence to scale profitably. Grocers are bolstering their e-commerce-focused category teams and reviewing stand-alone e-commerce financials to sharpen their focus on this business segment. The right operating model will balance decision rights between e-commerce and merchandising teams and implement analytics and capabilities to enable acceleration in e-commerce. E-commerce in grocery is at an exciting horizon in North America; now is the time to accelerate growth while gearing the e-commerce value proposition and infrastructure for future profitability.

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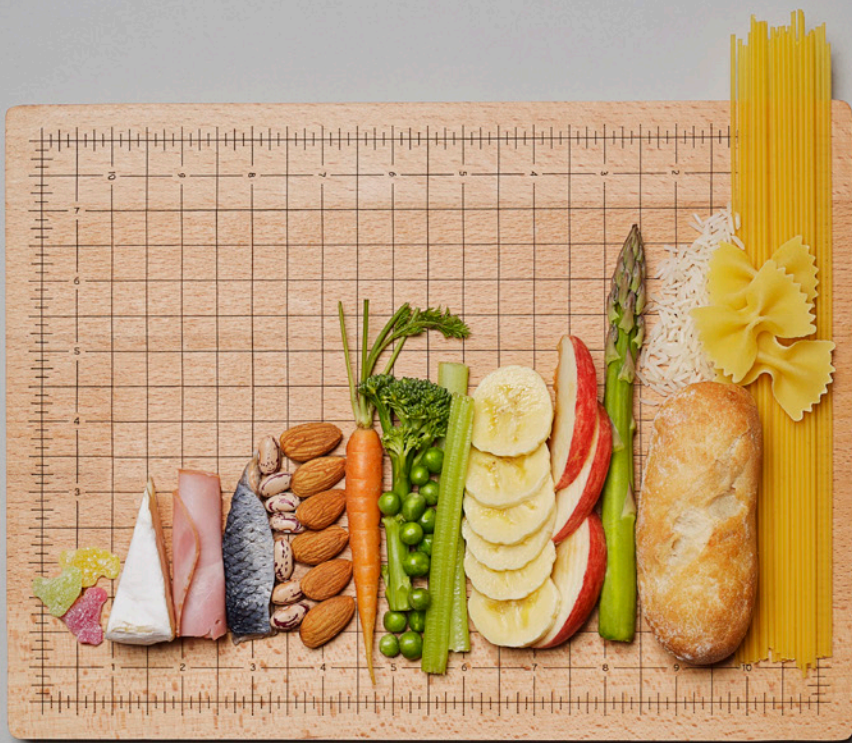
How advanced analytics can fuel growth

Organizational maturity will be a critical element for grocery retailers seeking to unlock the full potential of analytics.

by Andreas Ess, Holger Hürtgen, Jonatan Janmark, Gereon Sommer, and Björn Timelin

Advanced analytics, including artificial intelligence, offers a big opportunity for the retail industry. McKinsey Global Institute estimated in a study the potential annual value of artificial intelligence for the retail industry at $400 billion to $800 billion globally.

For grocery retail specifically, we see the potential for an incremental increase in earnings before interest and taxes (EBIT) of up to two percentage points if all use cases are implemented and the value is fully captured. Most of this value is driven by commercial use cases around assortment, pricing, promotions, and personalization (Exhibit 1). These are also some of the most mature use cases for which analytical approaches have begun to converge across the industry and

Exhibit 1

Most value is driven by commercial use cases that support actual business decisions

Shopping behavior since COVID-19 has started,[1] % of respondents in North America

Typical impact (contains overlaps)[1]
Percentage points of EBIT: (S) <0.1 (S) 0.1–0.25 (S) 0.25–0.5 (S) >0.5
★ Existing pilots and tests ★ In use in a few companies ★ Becomes standard

Enabler use case—no decision

Domain	Classic use cases (selection)				Innovative use cases (selection)	
Category management	Macro space allocation	(S) ★	Pricing (KVI identification, price recommendation)	(S) ★	NLP on customer reviews to support for (de)listing decisions	★
	Macro space order	(S) ★	Online or dynamic pricing	(S) ★		
	SKU listing or delisting	(S) ★	Markdown optimization	(S) ★	Automated product comparison (NLP)	★
	Assortment localization	(S) ★	Promo (historic effectiveness, forecast, optimization)	(S) ★	Automated product tagging (NLP, computer vision)	★
	Store clustering					
	Planogram (position, facings)	(S) ★				
Marketing	Personalized promotions	(S) ★	Marketing mix optimization (MROI)	(S) ★	Facial recognition for personalization	★
	E-commerce personalized content[2]	(S) ★	E-commerce improved product search[2]	(S) ★		
	Forecasting (category, market)		*Customer journey analytics*			
Purchasing	Vendor negotiation support	(S) ★	Indirect optimization (AI-based spend cube)	(S) ★		
Supply chain and operations	Store labor scheduling	(S) ★	Warehouse labor scheduling	(S) ★	NLP for customer service	(S) ★
	Store network (expansion, pruning, performance)	★	Warehouse "digital twin"	(S) ★	Seamless checkout (eg, Amazon Go)	(S) ★
	Energy optimization in store	(S) ★	Logistics network optimization		Inventory and shelf monitoring	(S) ★
	Order forecast and optimization (including shrink or out-of-shelf)	(S) ★	Route optimization, including CO_2 simulation	(S) ★	In-store tracking	(S) ★
					End-to-end product tracking	(S) ★
Others (eg, support)	People analytics (eg, hiring, churn)	(S) ★	Credit scoring	(S) ★	Sentiment analysis for customer service	
	Data ecosystems	(S) ★	Fraud detection	(S) ★		
	Retail media	(S) ★	Back-office process automation	(S) ★		
	Report optimization	(S) ★	Automated budgeting	(S) ★		
	Analytics self-serve	(S) ★				

[1]Impact partially overlapping—up to 2 percentage points in total realistic.
[2]On e-commerce revenues.
Source: McKinsey Analytics

standard analytics solutions are available on the market.

During the past five years, grocery retailers have moved beyond experimenting with advanced analytics and started to adopt these use cases in a systematic way. The majority of North American grocery retailers are now embracing advanced analytics and are investing in capturing its value.

While we observe these investments, we so far do not see that the potential value is captured in the profit and loss (P&L).

To determine what distinguishes analytics leaders from the pack, we analyzed grocery retailers along two dimensions: analytical and organizational maturity (Exhibit 2).

We found that capturing the value of advanced analytics depends even more on a retailer's organizational maturity than its analytical maturity. In fact, retailers can achieve results only if organizational maturity is in place—which is still the exception in the industry rather than the rule.

Exhibit 2

Most consumers expect to shop online more in 2021 than they did in 2020.

Analytical maturity

Organizational maturity (breadth of use)

⬤ ⬤ ⬤ Status of the majority
of North American grocers

Leading:
Data-driven decision making embedded in business processes

Advanced:
Standard business intelligence disconnected from decision support system

Basic:
Excel culture, reporting only

Analytics-led

2020

2025

Business-led

2015

Lab

Pilot and
proof of value

Enterprise-wide
adoption
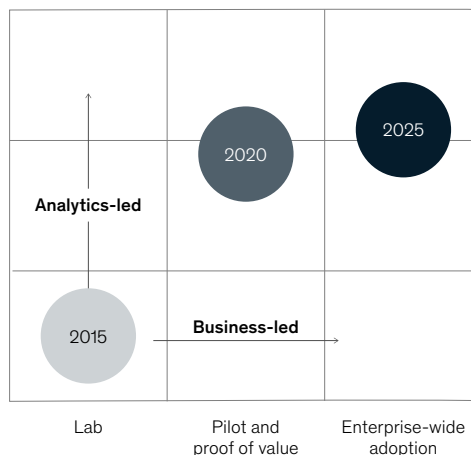
Analytics-led
• Build a small team of data scientists
• Assign a strong sponsor
• Identify and leverage quick wins to prove potential
• Systematize learning from data

Business-led
• Roll out analaytics products across the business
• Create new processes based on insights
• Embed organizational change
• Strong representation at board level
 (eg, through a chief analytics officer)

Source: McKinsey Analytics

Many grocers have made great progress on analytical maturity. Leaders in analytics have tackled the majority of fundamental use cases, such as pricing, mass promotion, and assortment optimization. Now, they have increasingly turned their focus to pursuing new use cases along the value chain and improving the existing use cases—for example, using more granular, real-time data. These efforts are often driven by a strong analytics unit, but adoption of these use cases in the business varies. The best analytics solution does not help if it is not used and understood by the respective decision makers (such as category managers).

Organizational maturity in many cases is the main barrier to going beyond partial adoption and realizing analytics' full potential. Organizational maturity encompasses both processes to technically embed and continually improve use cases, as well as constant change management with the users of the analytical insights—fostering understanding of analytics, ensuring it is embedded in daily processes, and measuring against new key performance indicators (KPIs).

An analytics use case, defined

An analytics use case describes an application of analytics and data to achieve an improvement of business performance and decisions. It defines the scope of change, a set of objectives with key performance indicators (KPIs), users affected, and data and analytics methods to be used.

Our analysis of winners—both digital natives and traditional grocers—highlighted five strategies that have helped them excel, particularly in organizational maturity.

1. Focus on strategic use cases instead of on data.

Value is driven by business decisions based on insights provided by data (see sidebar, "An analytics use case, defined"); vast quantities of data do not generate any value by themselves. Transparency on the value of a use case, and a clear road map for how and when to realize it, is therefore key.

Grocers should create a prioritized portfolio of use cases derived from strategic priorities with clear business objectives, and reallocate resources to those with the highest risk–reward potential. They should also group the defined use cases into larger units or domains (such as store operations or merchandising). This accelerates the change in a given business domain, because almost all of their decisions become more data-driven and, ideally, interconnected.

2. Create agile, interdisciplinary product teams.

One of the most crucial factors in extracting value from analytics insights is the translation process between business and technology. Many business teams don't fully understand how technology and data science teams can support them, and vice versa. As a result, businesses don't ask the right questions, while technology and data science teams try to answer questions that do not exist. This part of the analytics value chain

can be regarded as the "secret sauce," and traditional grocers have particular difficulty in achieving greater visibility and understanding between tech and business.

Winners create agile, interdisciplinary product teams that are led by the business and consist of people from business, analytics, and IT. Such an interdisciplinary team collaborates closely to achieve a defined business goal (for example, improve the delisting decision in assortment). In this approach, business is closely involved in the identification of use cases and also in designing the solution for the business case—either by providing a full-time resource in the role of product owner as part of the team or as part-time business owner. The business is key in closely defining the business objectives and use-case specifications, as well as in ensuring the necessary change in the business organization: process changes, understanding of analytics, and relentless measuring of P&L impact. The result is a product that ensures P&L impact and, above all, scalability.

3. Invest in large-scale change management to ensure use-case adoption.

Many use cases require that someone approach decisions differently or work in a different way. Therefore, deploying a use case often requires adjustments to processes, roles and responsibilities, and incentives as well as the acquisition of new capabilities. Merely giving employees access to a new tool and explaining it in a training session often is not enough.

For example, if pricing is automated based on analytics, this will have profound implications for the role of a pricing or category manager. While in the past they might have been focused on doing tactical adjustments to prices, they now might be responsible for setting strategic guidelines and providing input to the analytics team on how to further improve the pricing logic.

Even with smaller changes, we find that embedding the analytics insights deeply into the existing processes and workflows and investing heavily in building the required capabilities and understanding of the users is an elementary prerequisite to harvest the expected impact—and which is often underestimated.

4. Develop a fit-for-purpose analytics platform to maintain and scale multiple use cases.

Providing access to data and insights to many business users is a key way to drive adoption and promote organizational maturity. To achieve this goal, retailers must build a dedicated analytics platform.

Moving from legacy IT systems to a fully modernized big-data IT stack requires significant time and cost. But a complete transition may not be necessary—legacy systems can coexist with cloud-based data infrastructure. The most crucial components are data collection and an analytics platform consisting of a data lab, allowing for quick experimentation and a factory environment that can monitor, run, and scale use cases continuously. Grocers should then integrate analytics into back-end and front-end systems

incrementally, one use case at a time. Eventually having an advanced analytics platform, the data layer itself, and a visualization and results layer accessible to the entire organization boosts grocery retailers' organizational maturity.

5. Decide whether to buy an existing solution or develop one in-house.

Grocers do not need to reinvent the wheel to achieve business impact. But the choice between buying a proven off-the-shelf solution and investing the resources to develop one can be surprisingly difficult. Many organizations lack expertise in certain use cases, and they must also navigate complex requirements from technical and business perspectives.

In our experience, a successful vendor strategy takes a staged and differentiated approach. For use cases that have become a commodity and are at least in a widely available base version in the market (for example, forecasting and assortment), using external vendors and tools might be the fastest, cheapest, and least risky route. For use cases that can generate a competitive advantage or are still in early stages (for example, personalized promotions), a bespoke solution might hold more impact. Another option is to buy tools or code from vendors to start or accelerate use cases before bringing the solution in-house to create distinctive, tailored solutions.

———

All grocers must master advanced analytics to remain relevant. By now, for many important use cases, such as assortment, price, and mass promotions, standardized software is available in the market. This also allows for smaller retailers or retailers with lower analytics maturity to achieve first results quickly. For more analytically mature retailers, more experimental use cases, including localization of assortment or personalization of promotions, are the next frontier. To succeed, grocers must invest not only in technical solutions but also organizational capabilities, which will require significant investment in change management, driven from the very top.

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Automation opportunities in North American grocery

Recent trends and technological advancements have made automation viable across the value chain.

by Steven Begley, Vishwa Chandra, Prabh Gill, and Bill Mutell

Cost pressure in grocery is an evergreen topic. Despite unprecedented sales growth caused by the pandemic, grocers can still pursue many opportunities to become more profitable. As sales levels stabilize, both public and private companies will again face cost pressures. Using excess cash accumulated during the pandemic to invest today can help to manage cost pressures tomorrow.

Automation is an often underexplored cost lever in grocery, mainly because it historically required high capital investments and yielded lower or unpredictable ROIs. As other industries have shown, automation can help streamline labor-intensive practices, reduce rework, and create opportunities to foster more creativity within a company. We'll explore automation across different parts of the grocery value chain: stores, supply chains, last mile, and corporate centers.

Stores

For traditional formats, labor in grocery stores has long been the second highest profit-and-loss item (after the cost of goods sold). More grocers are now beginning to explore how automation can enable the reallocation of their workforce to areas that can be a differentiator in the marketplace.

Theft-detection software
Until recently, camera technology wasn't sharp enough to catch incorrect scans at self-checkout lines. By one grocer's estimate, at least $30 per self-checkout machine is scanned incorrectly or deliberately stolen each day. Grocers are beginning to explore solutions that use

camera technology and AI to pause and flag questionable transactions. Theft detection will be critical as grocers migrate to more economical checkout options.

Smart service counters
A common pain point among most North American grocers involves labor in deli departments. Staffing the service counter is unpredictable and frustrating for both customers (due to wait times) and employees (due to constantly changing demand patterns). To remedy this problem, grocers are using order-ahead technology through an app so that employees know what to produce. Before a customer enters the store, the deli counter can create the order during lower-traffic periods, cutting customer shopping time.

Electronic shelf labels
The ROI for electronic shelf labels historically hasn't been attractive for most grocers. However, one recent development is changing this equation: the more agile deployment of dynamic-pricing software, which allows grocers to reset prices (normally once the store has closed) according to local demand patterns. Dynamic pricing instantly alleviates the lag time in implementation with once-weekly price changes. To experiment with this technology, some retailers are placing the tags only in select areas (for example, planograms with high promotional density) or categories that take longer to change (such as in frozen sections). The combination of rising labor costs and dynamic pricing has cut the previous investment payback of four to five years to less than two years.

Cameras and robotics

In-store robotic equipment isn't new to the grocery format, which has used floor-cleaning robots for several years. However, the advent of surveillance cameras in stores has allowed for better tracking of inventory, planogram compliance, and in-stock measurement. These alerts can be pushed to store associates as tasks to fulfill in a prioritized fashion. New robotics can assist with replenishment while also doing more traditional tasks (such as cleaning) more effectively.

The best way to assess the business value of these solutions (and other labor-saving initiatives) is to build smaller-scale tests—for example, across a subset of stores or a banner. Historically, such tests have proven difficult, even for the most agile of retailers. The rapid response of grocers to the COVID-19 pandemic, however, has demonstrated that they are able to move at a remarkably fast pace and that customers will share feedback on what works and what doesn't. In addition, creating measurement plans is critical to support investment discussions once tests are completed.

Supply chains

Within supply chains, significant automation is already underway. Microfulfillment-center (MFC) providers such as Dematic, Fabric, and Takeoff are partnering with grocers of all sizes and operating models—from physical retailers (such as Walmart and Albertsons) to pure-play online retailers (for example, FreshDirect). At sufficient densities, MFCs can handle 4,000 to 5,000 orders each week, with 100 to 150 units picked per labor hour. These fully automated platforms also buoy the fulfillment economics, bringing home-delivery basket margin to five times the level of centralized fulfillment centers such as Ocado. The average cost per location of an MFC is now approximately $3 million and takes anywhere from four to 12 months to launch, providing a 70 to 80 percent internal rate of return when scaled appropriately.

Grocers are making additional investments in supply-chain automation, mainly in retrofitting existing distribution centers with picking tools that reduce cost to fill. According to McKinsey estimates, these supply-chain tools will generate more than $20 billion in value over the next three to five years.[1] Last, while more closely tied to AI than automation, improvements in inventory algorithms are helping offset rising capital costs by more nimbly predicting where to deposit goods in the value chain, given the more decentralized fulfillment ecosystem needed to support omnichannel.

Last mile

During the pandemic, e-commerce penetration in North American grocery tripled to 9 to 12 percent. This shift has suddenly made the last mile a busy and potentially profitable part of the value chain. Against this backdrop, several types of automation have become more common in grocery recently, and these developments have garnered attention.

Outsourced delivery labor

Traditional delivery options include company-owned assets, contracted

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[1] This estimate was derived from *Retail speaks: Seven imperatives for the industry*, McKinsey.com, March 2021.

delivery services, and parcel companies. Automation is playing an increasingly central role in the ability of outsourced labor models to execute effectively, giving rise to two new formats: in-house and outsourced gig networks (Exhibit 1). In-house networks give grocers much more control over talent pools and resource allocation. Larger retailers (such as Amazon and Walmart) are using their own labor and gig networks as a way of flexibly distributing resources when needed. The outsourced gig providers— such as DoorDash and Uber Eats—will often contract with retailers as needed,
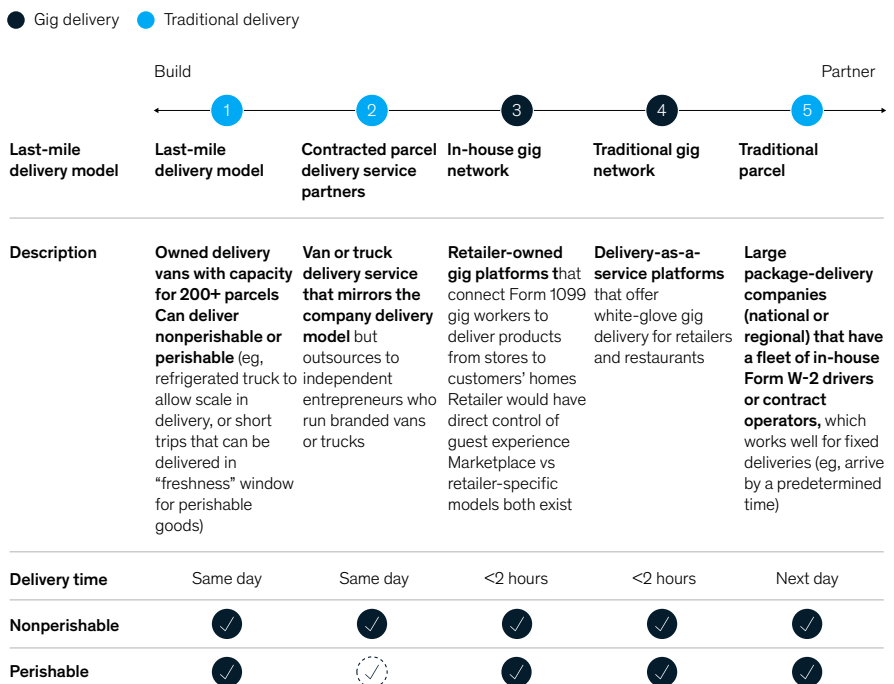
and the gig model allows independent contractors to choose their own hours, providing added flexibility.
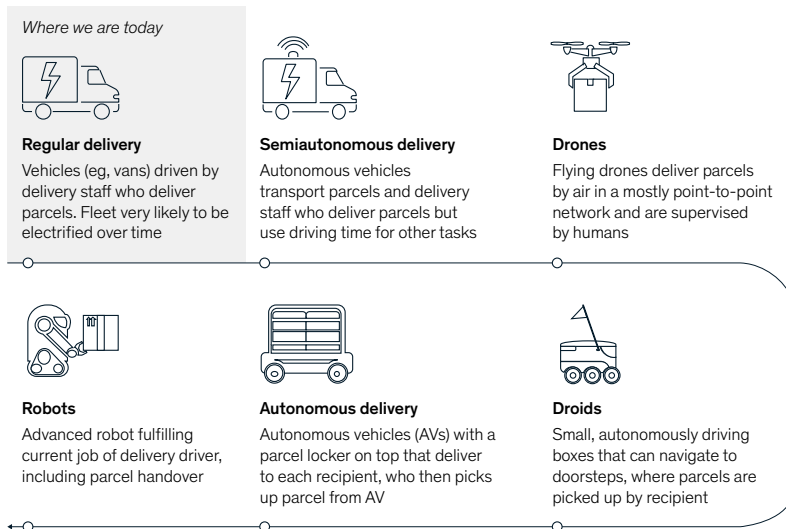
Autonomous vehicles

In the coming years, grocery retailers will shift from regular delivery to assisted autonomous delivery before moving into droids and fully autonomous delivery (Exhibit 2). Major retailers have already begun experimenting with these methods. The implications of this transition will be massive—both for technology companies that are currently developing solutions and for the grocery

Exhibit 1

A variety of models have emerged in last-mile delivery, enabled by growth in the gig economy.

● Gig delivery ● Traditional delivery

Build → 1 2 3 4 5 ← Partner

Last-mile delivery model	Last-mile delivery model	Contracted parcel delivery service partners	In-house gig network	Traditional gig network	Traditional parcel
Description	Owned delivery vans with capacity for 200+ parcels **Can deliver nonperishable or perishable** (eg, refrigerated truck to allow scale in delivery, or short trips that can be delivered in "freshness" window for perishable goods)	Van or truck **delivery service that mirrors the company delivery model** but outsources to independent entrepreneurs who run branded vans or trucks	Retailer-owned **gig platforms t**hat connect Form 1099 gig workers to deliver products from stores to customers' homes Retailer would have direct control of guest experience Marketplace vs retailer-specific models both exist	Delivery-as-a-service platforms that offer white-glove gig delivery for retailers and restaurants	Large **package-delivery companies (national or regional) that have a fleet of in-house Form W-2 drivers or contract operators,** which works well for fixed deliveries (eg, arrive by a predetermined time)
Delivery time	Same day	Same day	<2 hours	<2 hours	Next day
Nonperishable	✓	✓	✓	✓	✓
Perishable	✓	◌	✓	✓	✓

Exhibit 2

We expect new last-mile delivery methods to be developed, further expediting delivery times or reducing costs.

Where we are today

Regular delivery
Vehicles (eg, vans) driven by delivery staff who deliver parcels. Fleet very likely to be electrified over time

Semiautonomous delivery
Autonomous vehicles transport parcels and delivery staff who deliver parcels but use driving time for other tasks

Drones
Flying drones deliver parcels by air in a mostly point-to-point network and are supervised by humans

Robots
Advanced robot fulfilling current job of delivery driver, including parcel handover

Autonomous delivery
Autonomous vehicles (AVs) with a parcel locker on top that deliver to each recipient, who then picks up parcel from AV

Droids
Small, autonomously driving boxes that can navigate to doorsteps, where parcels are picked up by recipient

industry. One estimate suggests that the advent of fully autonomous vehicles could reduce the cost of delivery orders by an average of 40 percent.[2]

The last mile has long been capital intensive. However, the evolution of interpretations of labor and public sentiment (for example, California's Proposition 22 on app-based transportation and delivery drivers, which was approved by voters in November 2020) has given retailers more flexibility. In high-density environments, company-owned models typically yield better economics than gig networks, mainly due to network effects of batching and routed

delivery models. However, in subscale locales, gig economics present more favorable unit costs due to the removal of fixed labor. The embrace of gig economies and start-ups represents an early step on the road to more automation.
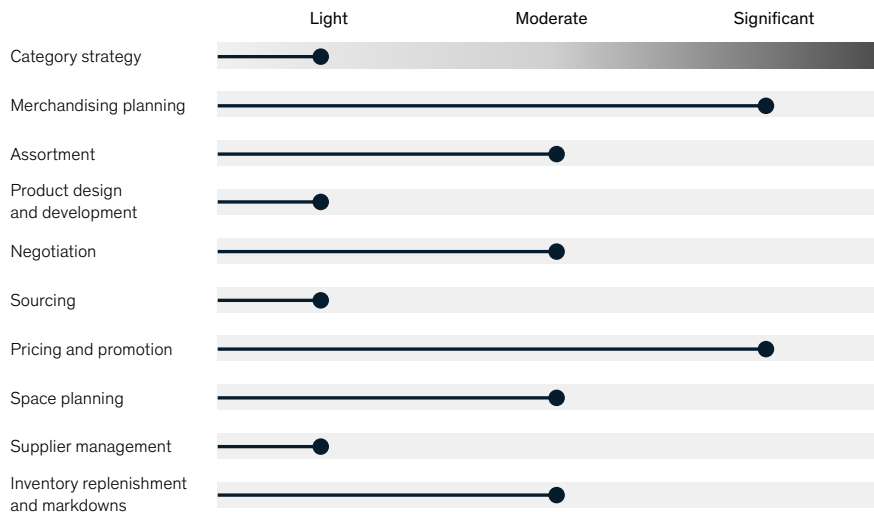
Corporate centers
While automation is newer to field functions (for example, stores and distribution centers), it has long been used at corporate and store support centers as a way of improving efficiency and reducing errors. In fact, automation will affect nearly every part of a retailer's operations (Exhibit 3). The following two

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[2] *Parcel delivery: The future of the last mile*, McKinsey.com, September 2016.

Exhibit 3

Automation will affect most elements of the merchant role.

Projected impact of automation by core merchandising activity

	Light	Moderate	Significant
Category strategy	●		
Merchandising planning			●
Assortment		●	
Product design and development	●		
Negotiation		●	
Sourcing	●		
Pricing and promotion			●
Space planning		●	
Supplier management	●		
Inventory replenishment and markdowns		●	

functions reinforce the opportunities that automation can unlock:

Merchandising and buying

In merchandise planning, automated predictive analytics are replacing time-consuming reports. Automated-replenishment models also support the movement of inventory while maximizing margins, saving the time previously spent on scenario planning. Even the more "artistic" elements of a merchant's role, such as program negotiations and supplier management, are being streamlined through automated playbooks and synchronous data sourcing.

Depending on the organization, pricing sits either within its own center of excellence or a hybrid model. Web

scraping (executed even at the zip-code level) helps pricing teams assess gaps in known value items compared with the competition and can dynamically adjust prices to remain competitive. This capability, coupled with electronic price tags, turns a price-change process that previously took four to eight weeks (based on aggregate point-of-sale data comparisons from vendors such as Nielsen or IRI) into a one- or two-day exercise.

Corporate functions

Automation has significant potential within several back-office support functions. In finance, for example, software can streamline accounts payable, accounts receivable, and financial planning and analysis. In

HR, automated criteria screening and aptitude testing can ensure that retailers place candidates in the right roles.

Such innovations can take many forms, depending on the end user. For example, HR team members can use expected attrition estimates and projected demand to forecast the number of new hires and place advertisements in external talent apps. Candidates submit resumes through the digital portal, which automatically scans for relevant criteria; an HR colleague then reviews the screened sample. This process can cut hiring times by more than 50 percent. Although integrating automation into these roles tends to take longer, it comes with an impressive ROI as a result of higher margins and improved accuracy.

One challenge is that conducting pilot projects is often more difficult due to the extensive reach of these systems. As a result, companies need to think carefully about which pain points to automate before making investment decisions.

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Vaccines will bring back more in-person dining, and grocery spending is expected to return to prepandemic levels. Grocers will need to reexamine their automation ambitions as a way of addressing structural costs and improving productivity across the value chain. Doing so can increase profitability levels and reinvestment potential not typically seen in such a traditional and competitive industry.

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Prioritizing flexibility: How grocers can get the most out of technology

Grocers have realized technology is core to their strategies, but flexibility is key to generate value from new technologies—now and in the future.

by Marcus Keutel, Gautam Lunawat, and Roger Roberts

In recent years, a wide array of technologies in areas such as sensors and data capture, automation, and AI have rapidly emerged with the potential to reshape the retail industry. One consistent trend has become clear: retailers that are capable of changing their businesses to capture value from new technologies across functions (such as e-commerce, supply chain, store operations, and customer engagement) are typically more successful. This ability to envision and act on opportunities faster than the competition has become a real strategic advantage.

Accordingly, grocery retailers have been on the hunt for technologies that can help them leapfrog competitors. But finding and implementing new solutions can also be accompanied by high costs and disappointing delays due to existing, inflexible legacy tech platforms that are often coupled with legacy ways of working.

Yesterday's technology strategies, such as multiyear projects with all value deferred to the final release, no longer suffice given the fast rate of change in grocery retail. These create fragile road maps, vulnerable to even small disruptions in cost, quality, and time to execute. On the other hand, pure online players and innovative incumbents are constantly on the move, so by the time companies complete their three-year road maps, the world looks different again. Fully automated replenishment software and microfulfillment centers, for instance, are streamlining supply and operations, with advanced analytics increasingly optimizing grocers' supply chains end to end. And who could have predicted the explosive growth of online grocery shopping in 2020 due to COVID-19 restrictions?

With e-commerce now a substantial part of their business, retailers are trying to build a truly omnichannel proposition and corresponding tech platform—no easy feat given the gaps between in-store and online commerce. At the same time, on the commercial side, merchants are increasingly working with largely automated, advanced tools to optimize pricing, promotion, assortment, and sourcing.

Agile, digitally savvy retailers that can derive the most benefit from new technologies will speed ahead of competitors and increase their ability to provide value to shareholders. Our analysis shows consumer and retail companies that are technology leaders increased total returns to shareholders (TRS) at a CAGR of 14 percent from 2017 to 2020, while laggards saw TRS fall by 5 percent CAGR (Exhibit 1). To deliver on this value potential, retailers should embrace five principles to guide their transformations and achieve the flexibility needed to excel.

Five principles to harness new technologies

To become a tech leader that can adapt to changing circumstances, grocers can look to five key principles for guidance:
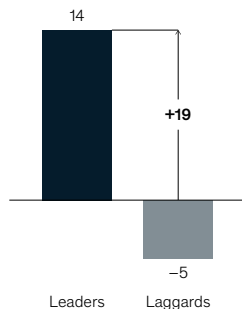
1. Build a 'product-led' organization

A nimble and successful tech organization is able to shift resources between

Exhibit 1

Leaders in digital outperform in total return to shareholders.
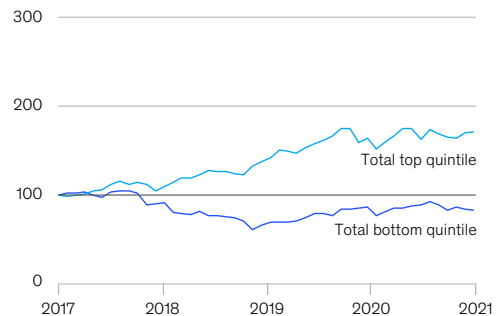
Consumer/retail companies with high digital quotient scores have higher TRS[1] growth

TRS CAGR 2017–20,[2] %

TRS of digital leaders has grown at twice the rate of digital laggards

TRS CAGR 2017–20,[2] %

[1] Total returns to shareholders.
[2] Four years of data (January 2017 to December 2020). Index 100 = January 2017.
Source: Capital IQ; McKinsey Analytics Quotient; McKinsey Digital Quotient

priorities on short notice. It's crucial for executives to build organizations around "products" (such as customer care or warehouse management) and not focus solely on applications. Leading grocery retailers define business domains and map out product teams for each domain, which could have multiple products. They should be defined at such a granular level that a small team of engineers can own the development end to end (Exhibit 2).

This cross-functional team comprises business and tech talent and is responsible for advancing the product's overarching vision, functionality, and performance. As market dynamics change, products and their teams can be expanded, reduced, or morphed into new teams to capitalize on new opportunities. These business domain product maps help organizations highlight strategic priorities, set measurable business

targets, and enable trade-offs when reprioritization is necessary.

While most leading players are building such product teams with in-house tech talent, the same applies for retailers opting for an outsourced or partner model. Smaller players, for example, may not be able to build a full-fledged in-house team in all technology domains. Still, the logic of a product organization would apply; technology partners should replicate a retailer's internal product logic. Regardless of the chosen model, some degree of internal control on technical quality will always be required for success.

2. Create a real tech workforce
To cope with underlying uncertainties and master new technologies, cutting-edge grocers are making sure they have the right talent and are providing employees with ongoing training opportunities to fill

Exhibit 2

Leaders define business domains and product teams.

Concept in brief

Business domain maps help define products by:

- highlighting strategic priorities and allowing retailers to set measurable business targets
- allowing trade-offs and prioritizations between domains

Domains as basis for organizing product teams along the domains

Business domain map—sanitized example

	Product domains	Product areas					
Channel	Channels	Web store	Express web store	App	B2B web store	Marketplace	In-store digital technologies
Expertise	Customer experience	Customer identity	Customer attraction	Customer retention	Discovery, search, and personalization	Checkout and payment	Customer care
	Merchandising	Sourcing and supplier management	Pricing and promotion		Assortment and service management	SKU information	
	Supply chain and fulfillment	End-to-end inventory management	Warehouse management		Fulfillment	Last-mile delivery	
	Enterprise	Operational finance processes		Human capital		Corporate business functions	
Platform	Platform products	Tech platform foundation			Data and analytics		

Customer exposure

skills gaps. Today, many grocery retailers rely heavily on external developers and contractors that may not always have the right capabilities or be able to deliver in a timely manner. Over time, building internal skills is likely less efficient but more effective when it comes to strategic digital systems that are designed and delivered in close coordination with business and functional colleagues using agile methods. The best organizations develop a strong internal engineering workforce complemented by flexible access to external talent in areas where it accelerates productivity or is critical for providing scarce skills.

More broadly, executive capabilities will need an upgrade as well. Skill building and lifelong learning on priority tech topics, such as establishing an enterprise resource planning modernization center or a cloud-migration team, should not stop at the operational-tech level. With technology becoming an important enabler of the whole business model, decision makers across the enterprise should also have a better understanding of how technology works, what it can do for them, and how to mitigate risks while pursuing value.

3. Build architecture modules driven by business strategy

The most successful new technology solutions follow a modular approach that is consistent and reusable across channels. This approach requires breaking

down monolithic legacy architectures into smaller, self-sufficient services—meaning they can be enhanced and deployed independently from other parts of the architecture. At the same time, these services should be able to provide data to other applications as needed without fragile point-to-point integrations. Breaking architecture down into modular pieces accelerates development velocity and provides a consistent customer experience across multiple consumer touch points (for example, in-store points of sale, web shops, and mobile apps).

Take, for instance, omnichannel basket calculation: this task is often a pain point for grocers, but when it is modular, it can be used in every channel, thus facilitating new features such as coupons, personalized promotions, and other forms of loyalty offers.

Another factor is influencing architecture renewal: stores are increasingly becoming nodes in an omnichannel ecosystem. Use cases include click-and-collect, local promotions, and last-mile deliveries. The underlying technology architecture must offer sufficient flexibility to integrate third parties, such as delivery partners.

4. Shorten time to market

Consumer behaviors are changing faster than ever. Shorter software release cycles allow retailers to better meet these shifting customer expectations by enabling experimentation, testing new capabilities quickly, and scaling up what works best. Instead of big code releases a few times a year, which are hard to adjust or adapt, companies must build the capabilities to provide new releases faster. This cadence can be as fast as multiple times a day in customer-facing systems, with monthly releases in back-end systems to incorporate user feedback. This accelerated release pace can be accomplished only if modern technology practices, such as automated code deployment and effective test automation, are in place.

5. Use data as the foundation for all improvements

Data are more abundant and flowing faster—and across more boundaries—than ever. Therefore, it is no longer enough to monitor structured transactional and supply-chain data. Grocers instead need to capture millions of daily events and interactions so they can be analyzed to optimize experience and productivity. New technologies in

Another factor is influencing architecture renewal: stores are increasingly becoming nodes in an omnichannel ecosystem.

this space are providing unprecedented flexibility to rapidly aggregate, process, and analyze these data.

With this capability, companies can keep close tabs on changing consumer demand. No longer is experience alone enough to make the best decisions. Retailers must complement it with data-driven decision tools—often powered by machine learning. Tailoring these tools to the most critical value drivers of the business is another truly strategic capability.

Data also improve decisions about where to invest the IT budget. Wherever possible, analysis of direct user feedback can identify areas to improve and inform decisions about further priorities. Investments into critical tools, such as A/B testing and performance monitoring, allow companies to gain better access to user feedback at scale and to act on it.

The agile approach in action

An international grocery retailer decided to double down on digital opportunities, but it needed to radically change its approach to technology adoption. To begin, leadership created a new board-level technology role: chief digital and product officer. Then, the retailer hired eight tech and product leaders who came from purely digital companies or competitors with more advanced tech strategies. It established an offshore tech hub and hired more than 90 engineers, in addition to strengthening the engineering capabilities at headquarters. On the system front, it transformed its underlying architecture, starting in the e-commerce space, where a monolithic system was incrementally replaced by smaller software-as-a-service (SaaS) offerings

and self-developed microservices. The retailer also invested in continuous integration and deployment capabilities and established quarterly, monthly, and even weekly business reviews to evaluate and improve the performance of its key products.

With this new setup, the grocery retailer increased the return on its tech investment and enabled code deployments multiple times per day. Within two to three months, it was able to launch multiple new products, including a new shopping app, a click-and-collect service, a scan-and-go feature, and an express delivery service. At the same time, its digital businesses grew rapidly. Before, e-commerce business had stagnated at approximately 500 orders a day. Nine months after implementing the new strategy, the company had increased the number of online orders to more than 20,000 per day. And since the outbreak of COVID-19, it has further multiplied the number of daily orders generated by its online business.

Setting the right priorities at the outset

To get started on a tech transformation, grocery retailers are using the following strategies:

— *Embrace the change as an enterprise-wide transformation.* Instead of being limited to certain functions, an enterprise-wide approach will maximize impact and prevent the change from creating different cultures within the company.

— *Measure what matters.* The primary goal in IT should be to increase growth and productivity in the core business,

which matters far more to the bottom line than shaving a few tenths of a percent off the cost of IT. Yet many IT organizations are measured only by cost versus revenue. Top executives should focus on business impact, and IT leaders should be sure to hold their people accountable to hitting the same metrics as their business colleagues. To be a real business partner, IT cannot measure itself solely by IT metrics.

— *Focus on tech opportunities that provide the highest business value.* An endless number of possible improvements exists, so companies should consider creating minimal viable products to demonstrate value quickly and build appetite for change. Choosing the right "battles" is critical: trying to implement change everywhere will result in comprehensive impact nowhere. Therefore, the focus should be on doing a few things well that create tangible value and the potential for a road map that is at least partially self-funding.

— *Shorten technology planning cycles.* Moving from an annual planning cycle to a flexible planning model on a monthly or quarterly level allows rapid prioritization and deprioritization of products based on their ability to continually generate value.

— *Make your entire leadership team accountable for the technology change in their domains.* True, agile transformation requires the entire board, the C-suite, and their teams to work across functions and silos.

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Grocery retailers have a golden opportunity to make better use of the innovation potential that technology is bringing. The path to success is not about picking one solution over another; rather, it lies in building the organization's capacity to drive change with tech leaders and other functions working together. The pandemic forced a new level of collaboration at a pace and scale not imagined before, and teams should build on the lessons from that difficult time as they chart their course toward a tech-enabled future.

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The potential for powerhouse private brands: An updated view

In the past year, consumers have snapped up private-label goods at grocers. Will this trend last beyond the pandemic? Only if grocers develop a compelling brand strategy and operating model.

by Steven Begley and Angus McOuat

Private labels, or what we aspirationally call private brands when they are fully executed, 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-brand goods—and have continued to do so. The fact that private brands are frequently less expensive than national brands has also helped as financially strained consumers tighten their purse strings. These two advantages—high availability and low price—made private-brand products considerably more appealing to consumers during the pandemic.

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

But will this private-brand boom be a short-lived one? In the near term, are retailers at risk of disappointing first-time buyers of private-brand products with a poorly thought-out offering? And as vaccinations reach full rollout and COVID-19 shows signs of abating, 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-brand game, the answers to 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 throughout the pandemic have shown that nearly 40 percent of US consumers have tried new products or brands since the onset of COVID-19. 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.

Private brands have been one beneficiary of this switching trend. Nearly one in five consumers said they bought more private-brand products during the pandemic than they did before the crisis. In our most recent consumer survey, in January 2021, more than 90 percent of US consumers indicated they will buy the same or more private brands after the pandemic, indicating its staying power (Exhibit 1). Consumers also indicated that they believe private brands have the same or better quality for less money, with availability only a minor driver of switching behavior.

Amid prolonged economic uncertainty, consumers' hunt for greater affordability might keep the private-brand 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 after the pandemic, especially because many retailers' private-brand strategies and offerings aren't explicitly designed to capture long-term customer loyalty.
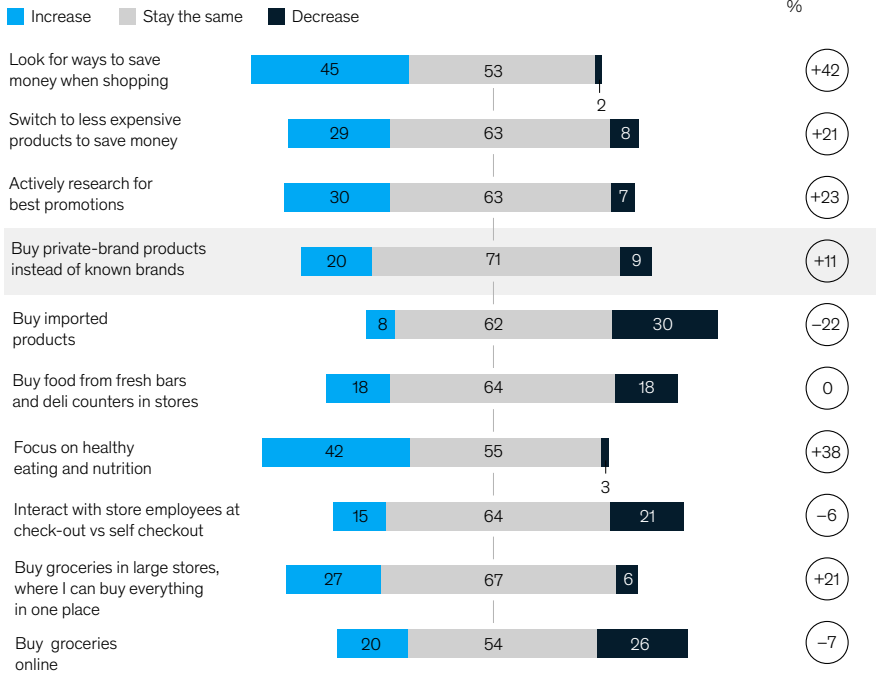
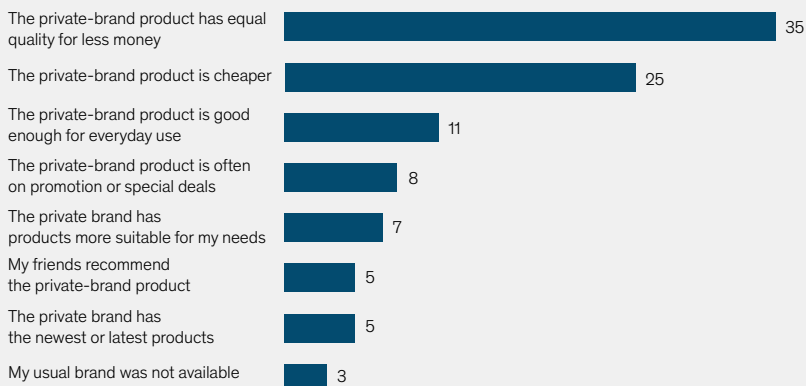Retailers can change that. And they should do so—fast.

Exhibit 1

Consumers will increasingly look for ways to save money in 2021 while focusing on healthy eating and nutrition.

Consumers plan to continue purchasing private brands, mainly because they offer equal quality for less money.

Grocery shopping attitudes in 2021 vs 2020, %[1]

Net intent,[2] %

■ Increase ■ Stay the same ■ Decrease

	Increase	Stay the same	Decrease	Net intent
Look for ways to save money when shopping	45	53	2	+42
Switch to less expensive products to save money	29	63	8	+21
Actively research for best promotions	30	63	7	+23
Buy private-brand products instead of known brands	20	71	9	+11
Buy imported products	8	62	30	−22
Buy food from fresh bars and deli counters in stores	18	64	18	0
Focus on healthy eating and nutrition	42	55	3	+38
Interact with store employees at check-out vs self checkout	15	64	21	−6
Buy groceries in large stores, where I can buy everything in one place	27	67	6	+21
Buy groceries online	20	54	26	−7

Top reason for buying more private-brand products, %[3]

The private-brand product has equal quality for less money	35
The private-brand product is cheaper	25
The private-brand product is good enough for everyday use	11
The private-brand product is often on promotion or special deals	8
The private brand has products more suitable for my needs	7
My friends recommend the private-brand product	5
The private brand has the newest or latest products	5
My usual brand was not available	3

[1]Question: Which of the following statements best describes your attitudes toward grocery shopping in 2021 as compared to 2020? You indicated that you plan to purchase more private-label products (eg, store brand products) in 2021 relative to 2020. Which of the following reasons best describes why?
[2]Net intent is calculated by subtracting the percent of respondents stating "decrease" from the percent of respondents stating "increase."
[3]Figures may not sum to 100%, because of rounding.
Source: McKinsey & Company State of Grocery Consumer Survey 1/13–1/25 n = 4,691 sampled and weighted to match the US general population 18+ years

Private brands as a way to win customer loyalty

Even as retailers have introduced new private-brand products and brands over the years, few have thought through the role of private brands in their businesses. Some private brands and products come into being simply because, for instance, a vendor offers to make a product at a lower cost and higher margin than a national brand. The retailer agrees—but doesn't carefully define this new product's value proposition or role in the assortment. Some retailers have been somewhat more deliberate in launching private brands: setting targets for margin and penetration rates, adjusting those targets as needed, and even making changes in their organizational structures to invest in store brands. 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-brand strategies can translate short-term switching into long-term customer loyalty. For some retailers, the private-brand offering might have been successful in the pre-COVID-19 environment but now requires reevaluation. For retailers that haven't invested meaningfully in private-brand capabilities, making bold moves is even more urgent.

Refine and pressure-test your aspirations for private brands
Now is an opportune time for a retailer to define—or redefine—its aspirations for its store brands, based in part on the

Retailers that seize this moment to reset their private-brand strategies can translate short-term switching into long-term customer loyalty.

maturity stage of private brands in the markets in which it operates (Exhibit 2).

The retailer should aspire toward a leadership position in its current stage and begin to move toward the next stage, with private brands becoming an increasingly critical contributor to long-term loyalty. Key areas in which to set aspirations and associated targets include brand awareness, customer perceptions, penetration, quality, value, profitability, and private brands 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.
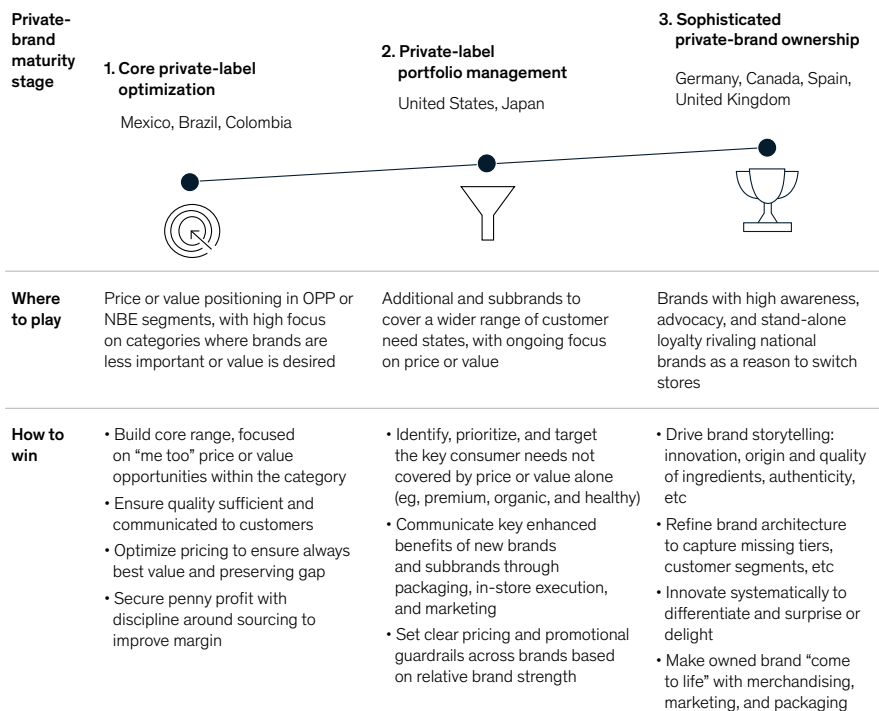
Conduct a detailed diagnosis and gap assessment

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

Brand strategy

Research often reveals that consumers recognize private-brand goods as lower-

Exhibit 2

Private-brand markets typically evolve in phases.

Private-brand maturity stage	1. Core private-label optimization	2. Private-label portfolio management	3. Sophisticated private-brand ownership
	Mexico, Brazil, Colombia	United States, Japan	Germany, Canada, Spain, United Kingdom
Where to play	Price or value positioning in OPP or NBE segments, with high focus on categories where brands are less important or value is desired	Additional and subbrands to cover a wider range of customer need states, with ongoing focus on price or 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, focused on "me too" price or value opportunities within the category • Ensure quality sufficient and communicated to customers • Optimize pricing to ensure always best value and preserving gap • Secure penny profit with discipline around sourcing to improve margin	• Identify, prioritize, and target the key consumer needs not covered by price or value alone (eg, premium, organic, and 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 or delight • Make owned brand "come to life" with merchandising, marketing, and packaging

Source: Expert interviews, market research

priced products but not as products that deliver on quality, innovation, or excitement. Furthermore, consumer perception of a private brand can differ markedly across categories or departments: at some retailers, for example, private-brand diapers are more expensive than the national brands, whereas private-brand soda is 20 percent cheaper than the national brands. Surveys have shown that even a retailer's own merchandising 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 brands that cross price tiers and categories, it should clearly define for each brand (and subbrand) a customer value proposition that meets a distinctive consumer need. This step might 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-brand 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 effectively 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 brands. Customers' impressions of many private brands 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 brands' 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 brands, many of which attract consumers precisely because of perceived value. Ideally, retailers would systematically compare the price of each private-brand SKU against internal and competitor benchmarks. Here, too, compliance with established guardrails becomes lax over time, national-brand promotions weaken the private-brand 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 brand'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-brand 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 brands have traditionally relied on price and shelf placement to fuel purchases, 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 purchasing at a category level and ensuring fair-share presence. For example, one retailer is blogging about its private-brand 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 brands face.

Packaging, too, is becoming more important for conveying private brands' value proposition. In the past, private-brand 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. For example, a leading private-brand player in the value segment has added a prominent callout on its packaging that announces its clean ingredients, differentiating it from other value national brands.

Retailers ought to consider the following questions regarding communications, marketing, and packaging of private-brand 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 harness our own channels (for example, point of purchase, store flyers, or own website) to market our private brands?

— 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 (such as origin of ingredients)?

Product design and sourcing

A retailer's private-brand strategy—especially its choice of either focusing on "me too" national-brand equivalency or introducing new features and benefits to a category—will greatly influence design and sourcing. Regardless of strategy, however, retailers would be wise to not only embrace the power of sourcing to produce private brands at lower cost but also increase their attractiveness to customers by focusing on design.

There are four primary areas in which achieving excellence in private-brand sourcing can help retailers reduce their cost of goods sold by as much as 10 to 15 percent (a potential margin improvement of 500 basis points), while maintaining, or even improving, quality to increase penetration and growth.

1. *Target costing.* Traditionally, the target cost for private-brand products was determined using a retail-back approach based on arbitrary target margin. New approaches, based on robust should-cost models that account for raw-material fluctuations, proper accounting on overheads, more efficient packaging, and logistics, can result in increased margins. By conducting supplier plant walk-throughs, interviewing category experts, and engaging in other fact-finding activities, retailers can jump-start their journey toward total cost transparency and develop a joint understanding with their suppliers on how to work together to lower costs on specific products and categories.

2. *Advanced analytics to scale cost transparency.* While retailers have shifted the way they examine costs at the product level, the recent rise of advanced analytics enables the development of parametric should-cost models and expands this approach from a few SKUs to thousands in a matter of weeks. By leveraging best-in-class digital request-for-proposal (RFP) tools such as Coupa and Scout, retailers can conduct market events at scale, collect and analyze data at a much more granular level, and negotiate with suppliers at the cost-component level.

3. *Negotiation approach.* The approach to retail negotiations has also evolved from price-focused to fact-based negotiations based on a detailed understanding of material costs and supplemented by comprehensive preparation. By developing should-cost models, retailers can build a

fact base to focus suppliers on cost reduction opportunities. While the science of negotiations helps retailers gain a greater understanding of cost drivers, they can master and deploy the art of negotiations. Efforts could include systematic capability building, targeted coaching on where to focus based on should-cost models and market benchmarks, and a more systematic use of negotiations role-playing to pressure-test and refine each buyer's approach ahead of supplier conversations. By doing so, retailers can develop a new muscle within their organization that can help create value beyond product costs.

4. *Product development.* A copycat approach to private-brand product development has evolved to delivering better value for customers using design-to-value (DtV) methods and a focus on product innovation and sustainability. DtV can improve product and packaging design and specifications through a deep understanding of what consumers really value while also allowing private brands to leapfrog national brands. As consumers become increasingly comfortable with buying private brands, retailers can more assertively introduce new products with features and benefits that surpass those of traditional consumer goods brands. After all, retailers have the advantage of a wealth of consumer insights; they see trends across brands and are therefore privy to customer patterns and preferences that may not be visible to individual consumer goods manufacturers. Many retailers that exclusively or primarily carry private-brand products have built

fierce customer loyalty by becoming trendsetters, with their private brands providing a "halo" to their retail banner.

Done right, achieving excellence in sourcing could potentially finance the entire private-brand program. Retailers could identify which product categories have the most attractive opportunities to improve profits and quality and then develop new, savings-focused key performance indicators (KPIs). The savings could then be used for price investments, with the goal of boosting private-brand penetration. In their journey toward excellence in product design and sourcing, retailers could think about the following questions:

— Do we have the capabilities in place to achieve total cost transparency? What are ways we can better understand product costs at scale to work with our suppliers to reduce them?

— Does our current negotiating approach and process incorporate both the art and science of negotiations? Do we conduct enough role-plays and mock negotiations to pressure-test our strategies and build negotiating muscle across the organization?

— What is our process and framework for aligning on design priorities? Does it allow for sufficient input from category teams to develop a DtV approach on specific products and categories?

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

product opportunities? Are we able to conduct market events at scale and use the power of advanced analytics to analyze thousands of SKUs?

— In what categories is our private brand mature enough for us to get ahead of consumer goods manufacturers by introducing innovative or differentiated products?

Organization and operating model
There's no one-size-fits-all model to support private brands. 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 are in charge of execution.

Centralized teams are most critical in the early stages of private-brand 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-brand markets, where functions manage differentiated brand standards and innovation pipelines. On the other hand, in markets with more modestly developed private brands, where the focus is typically on price differentiation and me-too offerings, we have found that a lean, centralized team is most effective 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 products, 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.

For retailers that set bold aspirations and move quickly to fill any capability gaps, private labels can soon become powerhouse brands.

To figure out the 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-brand value chain?

— What is the role of the centralized private-brand 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?

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

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