

Perspectives on retail and consumer goods

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Perspectives on retail and consumer goods is written by experts and practitioners in McKinsey & Company's Retail and Consumer Packaged Goods practices, along with other McKinsey colleagues.

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Foreword

I hope you had a great summer and enjoyed some time with family and friends. It seems 2015 is shaping up to be another busy and successful year for many of you. Consumer sentiment is on the upswing in many European countries, the US economy is gaining traction, and in general the outlook for developed economies is positive. On the other hand, China's growth momentum is slowing, while Russia and other oil-rich countries continue to face challenges. Consumer-goods and retail executives certainly have more than enough to think about when it comes to managing the day-to-day business and the annual budget.

Yet I'm sure most of you are already thinking ahead. What will the world—and the consumer sector in particular—look like in 5 or 15 years? We read news reports about Alibaba's rapid rise to become one of the world's most valuable companies, the strong growth of e-commerce players Amazon and Zalando, Google and Tesla's efforts to develop self-driving cars, and other potentially game-changing and paradigm-shifting events. What are the implications for the consumer sector as a whole, for specific product categories, and for your company?

For example, will consumer and retail companies continue to manage IT as a cost line, with a focus on efficiency, or will technology become the most important competitive advantage? Will our largest markets be the same ones as today, or will the majority of our sales come from regions in Brazil or China that some of us haven't even heard of yet? Will retailers and consumer-goods companies remain distinct from each other, or will they become fully integrated direct-to-consumer companies (which is already starting to happen in the apparel industry)?

No one can predict what will happen in 2020 or 2030. But I believe that consumers and our industry will change more dramatically than ever; business will be fundamentally different. These developments can be exciting and energizing, rather than a cause for sleepless nights.

Management is all about finding the right balance between addressing short-term business needs and opportunities and setting a long-term direction for the future. One of my colleagues calls it "having a microscope for the daily business and a periscope for future direction setting." In this edition of our

journal, we tackle both elements—the first half focuses on emerging markets and the second half on concrete business levers such as labor scheduling and implementation excellence. One highlight of this edition is an interview with Doug Gurr, Amazon China’s president, whose insights on what the future might look like were an eye-opener for me.

I hope you, too, find each of the articles in this edition more than worth your time. Enjoy!



Jörn Küpper
Director, Cologne

This edition of Perspectives on retail and consumer goods is available on mckinsey.com in several digital formats: HTML, PDF, and e-book (for iPad, Kindle, Sony Reader, and other devices). Each article is also available on the McKinsey Insights app. We welcome your thoughts and reactions; e-mail us at Consumer_Perspectives@McKinsey.com.





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Modern grocery and the emerging-market consumer: A complicated courtship

In some emerging markets, the response to modern grocery formats has been tepid. What's a modern grocer to do?

Peter Child, Thomas Kilroy, and James Naylor

Just 20 years ago, modern grocery retail appeared poised to conquer every consumer market in the world. Ambitious European grocers, having blanketed their home countries with supermarkets and hypermarkets, began setting their sights on growth both within and beyond the continent. They held particularly high hopes for China, India, and other emerging markets, where fast-rising consumer spending seemed to presage an unprecedented demand for gleaming new stores with large assortments, wide aisles, and bright lighting.

In the 1990s, the term “modern grocery retail” was essentially a proxy for a small group of multinational grocers including Ahold, Aldi, Auchan, Carrefour, Costco, Lidl, Metro, Tesco, and Walmart. It was widely presumed that these retailers’ entry into any market would lead to the demise of the traditional

trade—the family-owned grocery chains, small independent stores, and informal merchants that at the time accounted for the vast majority of grocery sales in emerging markets. The prevailing expectation was that although there would be local differences due to cultural specificities, in every country the retail landscape would eventually consist of a combination of modern formats: full-line supermarkets and hypermarkets, convenience stores, and discounters.

These assumptions have been proved wrong. Global grocery giants are struggling to grow profitably in many emerging markets. Traditional trade has proved remarkably resilient. And the market and channel structures taking shape in individual emerging economies are distinct from one another, following no obvious pattern.

Why did this happen? What, if anything, did multinational grocers do wrong? And what does it mean for the future of modern retail in emerging markets?

The hypermarket's shortcomings

To understand the disparity between early expectations and the current reality, it's useful to examine the roots of the two quintessential modern-trade formats: the supermarket and the hypermarket. The hypermarket in particular—whether in its European form (in which food anchors a massive selection of nonfood items) or its North American one (the “supercenter,” which represents the successful injection of food and grocery into a general-merchandise discount store)—was widely regarded as unbeatable. By offering tens of thousands of products in an immense building just outside or on the edge of a town or city, a hypermarket could operate at a level of productivity that other grocery formats struggled to match. Hypermarket operators passed on these efficiency gains to consumers in the form of lower prices, which served to reinforce hypermarkets' advantage.

In their first forays into other developed markets abroad, major retailers relied heavily on the hypermarket format. When French retailers Auchan, Carrefour, and Promodès opened hypermarkets in Spain during the first years of Spanish economic reform, they quickly captured a large fraction of that country's overall grocery sales and dictated the market structure that remains in place to this day.

Expansion across Europe was an exciting growth prospect, but even more enticing to retail leaders and investors was the growth potential of emerging markets. Over the years, that potential has become even clearer: by 2025, we expect emerging markets to account for \$30 trillion in consumer spending, or nearly half of global consumption.¹

When multinational grocers entered emerging markets, they again relied on the grocery formats that were

working so well in the developed world. But, in retrospect, it's clear that the countries in which the hypermarket prospered had several characteristics in common: good road networks and high or fast-rising car-ownership rates, a large middle class that enjoyed decent wages and stable employment, and a high proportion of rural and suburban households with enough room at home to store groceries bought in bulk. Also, those markets had grown to maturity at a time when many women didn't return to work after having children and therefore had time during the day to drive to and from the store. The hypermarket format draws heavily on consumers' time, ability to travel, and storage capacity.

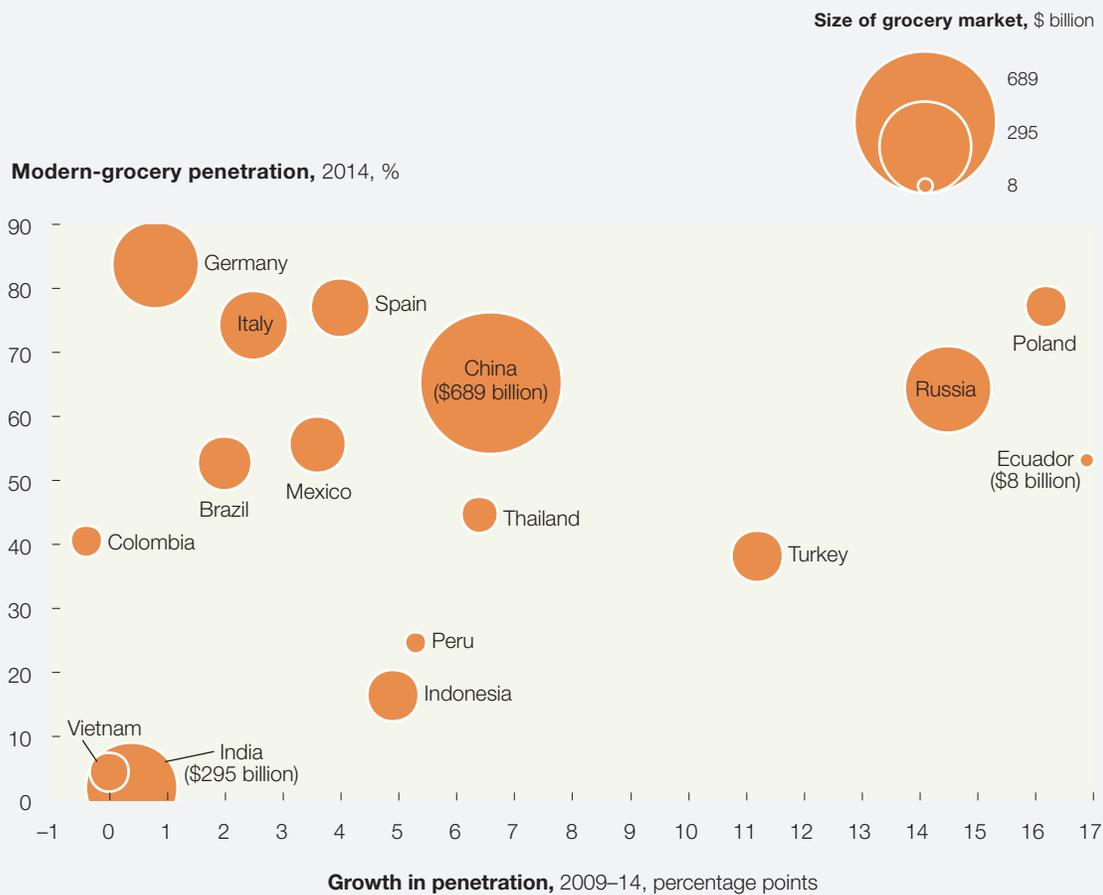
In emerging markets, retailers encountered an entirely different context. Consumers were less affluent and lived in urban areas; many didn't own a car, couldn't afford to travel to and from a relatively far shopping destination, had no room at home to store purchases, or all of the above.

A new respect for localism

Further complicating matters, emerging markets weren't just different from developed markets; emerging markets also differed from one another in nontrivial ways. That was true in the 1990s and it remains true today. Based on our research—which involved in-depth study of the retail sector in ten developing countries in Asia, Eastern Europe, and Latin America, as well as interviews with more than 20 local retail and consumer experts and analysis of channel-growth data in these markets—we've developed a perspective on the factors that have hampered the growth of modern trade in emerging markets.

On both the demand side (what customers want from retailers) and the supply side (the means by which retailers can deliver what customers want), different factors shape the retail ecosystem in each country. Together, these factors produce wide variability in the level of modern-trade development in countries around the world (Exhibit 1).

Exhibit 1 Modern-trade penetration and growth vary widely by market.



Source: Euromonitor International; McKinsey analysis

On the demand side, for instance, food-shopping habits have turned out to be largely localized and deeply entrenched. Emerging-market consumers tend to prepare their own meals and cook more than their peers in developed markets do, and they are accustomed to shopping at open-air market stands or small neighborhood grocery stores that offer a familiar selection of fresh food and household staples. They don't necessarily perceive customer service at modern retailers as superior to that of the traditional trade. Customers of India's *kirana* stores—small, family-owned retail shops in or near residential areas—already benefit from personal service from the

store owner, free home delivery, and credit and cash rebates if they remain loyal.

On the supply side, a big factor is the informality of traditional trade: many small retail businesses rely on unpaid labor from family and friends, pay no rent because they own their storefronts, and don't pay corporate taxes. Modern retailers cite this informality as a major challenge when competing with local retailers. A European hypermarket chain found that its considerable operating-cost advantage from better sourcing and supply-chain processes was canceled out by the fact that it was paying taxes while local competitors were not.

Another major factor affecting modern trade is public policy. India's restrictions on foreign direct investment have limited the growth of modern retail there; in China, by contrast, city governments are assessed on the level of economic activity and foreign investment they attract, which makes them biased toward supporting modern trade. As a result, modern-trade penetration in China's largest cities has grown significantly over the past 15 years.

A further supply-side factor in emerging markets is the fragmented supplier base, which places a natural limit on the benefits of scale. A retailer can't source products as efficiently as it would in a mature market because it must buy from a complex network of regional and local entities. And even retailers with a national buying team won't easily find national manufacturers who are eager to partner with them—a point we pick up on later.

Incumbent advantage is yet another powerful factor shaping retail ecosystems. Today's market dynamics tend to become tomorrow's market structure—so, for example, in markets in which a highly efficient wholesale system serves the traditional trade, it becomes much harder for modern grocers to gain a foothold. That said, wholesalers can also be vanguards of modernization. In Turkey, for instance, some Bizim Toptan stores have developed a substantial retail business. These wholesalers-cum-retailers illustrate the fact that ecosystems in emerging markets are partly shaped by players that can concentrate and coordinate a critical mass of what otherwise is a complex set of routes to market.

Seven strategic levers for success

In parts of the world where the market structure is itself still in a formative stage, retailers need a bespoke strategy. Our research and experience suggest seven strategic levers that lead to success in emerging markets. These levers—having to do with delivering what consumers want, working effectively with other players in the ecosystem, and generating lasting productivity advantages—reflect perennial concerns for retailers everywhere, but

they are especially critical in helping retailers secure a profitable future in the world's fastest-growing economies (see sidebar, "Questions to test your emerging-market strategy").

The levers are by no means comprehensive. For one, they don't touch on digital technology, which may well be just as important in emerging markets as in developed ones; indeed, rapid adoption of smartphone technology may allow emerging markets to leapfrog more mature markets and reconfigure the value chain farther upstream (for example, by giving smaller suppliers direct access to national and even global markets). Rather, we draw attention to areas that we believe require deliberate action in emerging markets.

1. Prioritize proximity.

Urban consumers with limited budgets and smaller homes often prefer to buy small amounts frequently, both for immediate consumption and for stocking up. And where trading space is constrained, proximity formats offer a more realistic prospect of economic returns for the retailer. Modern retailers can benefit from their experience operating smaller urban formats in developed markets—banners such as Albert Heijn's AH to Go in the Netherlands or Tesco Express and Sainsbury's Local in the United Kingdom.

One market in which small-format stores have been the major driver of modern-trade development is Indonesia. Sales through the convenience-store channel are growing at a rate of more than 25 percent per year across the country. In fact, the increasing dominance of convenience stores, known locally as mini-marts, has led to a contraction in the number of supermarkets and hypermarkets. The mini-mart chains mimic *warungs*, which are small family-owned retail or restaurant businesses that play a central role in Indonesian social life. Although the mini-marts are run by modern retailers—in addition to leading national chains Alfamart and Indomaret, international players such as Circle K and 7-Eleven have moved into the market—the customer's experience in mini-marts is not so different from that in *warungs*.

Questions to test your emerging-market strategy

Proximity

- Do you have a clearly defined small-store format?
- Have you built capabilities for local assortment tailoring?
- Do you have a nimble supply chain—one that can make small, frequent deliveries to stores with limited stockroom space?
- What is your property-acquisition plan for building a small-store portfolio? For example, have you identified independent businesses you could acquire or partner with?

Pricing

- How good is your price perception among consumers? Are you the acknowledged price leader in the market?
- What's driving price perception? Do you know what your “key value items” are? How well do you compete on basket prices for your main customer segments?

- Is your pricing philosophy understood by customers and evident in your stores day after day, week after week?

Productivity

- If local labor costs were to rise by 10 percent, would you still be profitable?
- Who in your organization is championing process improvement and labor efficiency?

Manufacturer relations

- Do you understand the cost structure and profitability of your major suppliers?
- Who are your most important suppliers for present and future growth?
- How should you propose sharing the proceeds of growth?

Government affairs

- How broad and deep is your network in and around government?

- Do you understand policy makers' concerns, and have you communicated yours?
- Who on your team is in charge of government relations? Are the primary objectives clear?

Traditional-trade partnerships

- How well do you understand the existing traditional-trade structure?
- Who are the best traditional-trade players, and what can you learn from them?
- Are there opportunities to build your retail brand through franchising, supply agreements, or earn-out acquisitions?

City-based growth

- Do your growth plans match the projected growth of cities and metro areas in your principal markets?
- Have you tailored your route-to-market and commercial models to each of your prioritized cities or city clusters?

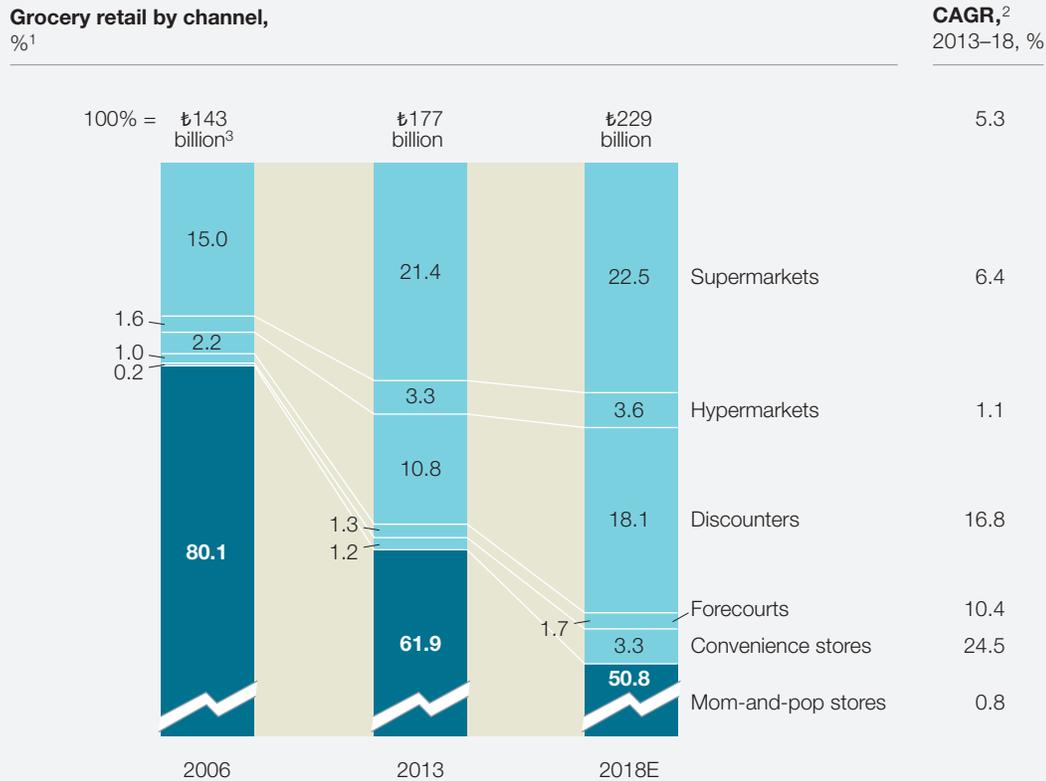
2. Keep prices low—and make sure consumers know.

The prediction that emerging-market consumers would initially shop at discounters and then “graduate” to supermarkets hasn't come true. Discounters, or retailers that exhibit at least three of four core discounter characteristics—low prices, limited range, low-cost store retrofits, and ultra-simple operations—have more than held their

own against supermarkets. In Turkey, for example, discount stores are a fast-growing channel, largely due to the success of local companies such as A101, BIM, and Şok (Exhibit 2).

Perhaps the success of discounters shouldn't be so surprising, given the stature they enjoy even in one of the largest and richest retail markets in the

Exhibit 2 The channel structure in Turkish retail is changing rapidly.



¹Figures may not sum to 100%, because of rounding.
²Compound annual growth rate.
³As of Aug 2015, \$1.0 = ₺2.8.
 Source: Euromonitor International; McKinsey analysis

world: Germany. Low-price stores can establish a dominant position in markets that are going through rapid increases in disposable income (as was the case, of course, in postwar West Germany). When the first modern-trade stores to open in a market are discounters, they can set price expectations permanently.

Other modern formats can also compete on price, but they have to work harder to get consumers to notice. Our research suggests most modern retailers don't get full credit for the value they offer. This is the case with Indonesia's hypermarkets, which typically are cheaper places to shop than *warungs* but haven't been

able to convey that message to enough consumers. Some common modern-trade practices such as high/low pricing can actually undermine a retailer's value message. In Peru, where bodegas and market stands account for some 80 percent of grocery sales, we found that modern retailers—despite often having lower full-basket prices than traditional retailers—nevertheless lag behind traditional retailers by more than 15 percentage points in consumer perception of low prices.

3. Obsess over productivity.

In markets where labor costs are low, it can be difficult to retain a relentless focus on productivity. But wages

are rising fast in emerging markets and bad habits are notoriously hard to unlearn. Retailers that have been obsessed with productivity have achieved striking results. BIM's decisions on new-store openings in Turkey are driven as much by logistics-network optimization as by local demand attractiveness. BIM follows a "mushroom" expansion model: it grows to high density in specific neighborhoods within a city, using retail formats that require low capital expenditures. The high density of deliveries has allowed it to solve the small-format logistics puzzle that has tripped up many big-box players.

Corporación Favorita in Ecuador offers another example of operational excellence: its just-in-time inventory model of daily deliveries essentially eliminates backroom stock. To ensure full control of store operations, it eschews direct store delivery, managing all flows through its central warehouses. This focus on operations has enabled the company to successfully manage a complex format portfolio.

4. Make the business case to manufacturers.

A rarely discussed obstacle to the expansion of modern trade in emerging markets is the fact that established manufacturers don't have much incentive to do business with modern retailers. Branded manufacturers enjoy high margins supplying small shopkeepers, who have little negotiating leverage. Why would they want to jeopardize that business in favor of modern-trade retailers with initially limited volumes and terms that are often less vendor friendly (especially if the retailer is a subsidiary of a global company)?

To woo major manufacturers, modern retailers may need approaches that are as creative, collaborative, and mutually beneficial as those they employ in developed markets. One argument full-line modern retailers can make is that branded manufacturers ought to support them rather than discounters. After all, in markets where discounters dominate, consumers can shift en masse away from branded products toward private-label goods.

5. Educate policy makers on the benefits of modern trade.

As mentioned earlier, government intervention can play a critical role in how, and how quickly, modern trade develops. In China, the strong central mandate to provincial and municipal authorities to create the necessary infrastructure for modern retailers—not just thousands of miles of new roads, but also urban planning that integrates modern-trade requirements into traffic patterns and real-estate zoning—has yielded extraordinarily rapid development.

Modern-trade players would do well to communicate the benefits of modern retail to government officials. They could, for instance, make a strong case that modern retailers can do a better job than traditional trade in providing safe and cheap access to high-quality food and household goods.

6. Consider partnering with the traditional trade.

One growth strategy for modern-trade players involves partnership with—rather than competition against—the traditional trade. The strategy has clear advantages: it allows a modern retailer to leverage the network and personalized service of the traditional trade while minimizing capital investment.

Eurocash in Poland is an example. Although its cash-and-carry stores and distribution centers play a wholesaler role, Eurocash also welcomes traditional-trade retailers as franchisees under its abc convenience-store banner (approximately 6,000 stores) and its Delikatesy Centrum banner (approximately 1,000 stores). This franchising approach has allowed Eurocash to grow quickly and profitably. Another example of partnership with the traditional trade comes from Grupo Éxito in Colombia: small retailers that join its Aliados Surtimax network receive Surtimax signage and fixtures, access to Grupo Éxito's portfolio of private brands, and business and management training. Grupo Éxito has rapidly built a network of more than 500 stores at an extremely low capital-expenditure rate of less than \$500 per store.

7. Adopt a city-based strategy.

When a market is in a relatively early state of modern-trade development, national borders can be unhelpful in scoping and designing a retail network. Rather, retailers should concentrate on getting to scale in cities or city clusters.² Thus, Supermercados Guanabara, the market leader in Rio de Janeiro, has confined itself to the metropolitan area and operates just 23 stores—yet it outperforms formidable competitors, including Carrefour and Walmart.

In China, some retailers have chosen to concentrate first on one city or city cluster, be it Shanghai or Shenyang, before expanding nationally. Similarly, modernization in India's retail sector will most likely happen through a series of players expanding in individual cities and states, rather than through a “big bang” national expansion plan.³



For any modern retailer, success in emerging markets isn't guaranteed. Our research confirms the complexity and local specificity of market development and the degree to which it depends

on initiatives taken not just by retailers but also by governments, manufacturers, wholesalers, and others in the local retail ecosystem. International retailers thus need to become experts at local tailoring. That said, operating in emerging markets still unquestionably requires excellence in core retailing competencies: marketing, merchandising, supply-chain management, and talent development, to name just a few. Retailers that excel in all these areas in the context of markedly different emerging-market structures will, in a sense, have conquered the world. ■

¹ See the compendium *Winning the \$30 trillion decathlon: Going for gold in emerging markets*, August 2012, mckinsey.com.

² For more on how to develop a city-based strategy, see Udo Kopka, Stefan Rickert, and Markus Schmid, “Pinpointing the markets with the highest growth potential,” *Perspectives on retail and consumer goods*, Winter 2013/14, mckinsey.com.

³ For more on growth opportunities in India, see *Understanding India's economic geography*, October 2014, mckinsey.com.

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Amazon China's president on 'transformative' technologies

Doug Gurr reflects on how China differs from Western markets and what role data informatics will play in the future of retail.

James Naylor

Doug Gurr had been a global vice president at e-commerce giant Amazon for less than three years when he was asked to take on a new challenge: lead the company's efforts in the fast-growing, hypercompetitive Chinese market. In September 2014, Gurr relocated to Beijing from his home in the United Kingdom. Today, he is in charge of an operation that employs approximately 5,500 people.

Gurr recently spoke with McKinsey's James Naylor. Excerpts of the conversation follow.

McKinsey: *During your entire retail career, you've championed investments in technology and innovation. Are you finding the technology in China to be different from what we see in more developed markets?*

Doug Gurr: Yes. The technology in China is phenomenal. You can see multiple ways in which the country is leapfrogging. For example, there's not much of an established physical retail infrastructure, so people are going directly to a purely online world. They don't go to a physical store at all—they simply look online and then purchase. If you talk to a group of Chinese women between the ages of 20 and 25 and ask them where they shop, they'll just look at you like you're a bit stupid. "I've never been to a store. Sure, I buy fresh food at stores—but for anything other than that, why would

I ever go to a store?" The world in which consumers get their insight and information exclusively online is very different. Social shopping, for instance, is an enormous phenomenon in Asia.

Already, 4 of the 15 largest Internet businesses by market cap are Chinese. The pace of innovation and the quality of the mobile experience in China in many ways far outstrips what you see in the West; it's gone down a divergent path. Again, there's a lack of physical infrastructure, so in areas like banking China is leapfrogging—going directly from cash to pure mobile e-banking.

Another example of leapfrogging is the use of geolocation. There's very little mapping in China, and there are many areas with no street addresses, but China has solved these logistics problems with geolocation. You wouldn't have thought you'd see bicycle rickshaws with better point-to-point geolocation and better GPS-enabled devices than you see anywhere else in the world. It's amazing and exciting—there's a blend of rough, old-fashioned ways of doing things coupled with technology that is way ahead in terms of the use of data informatics.

McKinsey: *Do you think the rest of the retail world will eventually look like China? In other words, will physical retail become irrelevant*

everywhere? What do you think will happen to the retail value chain?

Doug Gurr: One of the megatrends of the next five to ten years will be e-commerce moving from a primarily national to an international business. That's where a lot of the energy in China is going. It's about refining the answer to a simple question: What is a retailer for? The job of a retailer is to connect a product anywhere in the world to a customer anywhere in the world—to provide that customer with the best information to aid discoverability and guide purchase decisions—and to do it with as little friction and as quickly and cheaply as possible.

No one is saying that physical retail will disappear. Physical space is a fantastic way of discovering products. But it's also time consuming and expensive compared with a truly optimized, truly evolved digital-discovery experience. So I think there will be a role for physical stores, but I wouldn't be too sanguine that such and such a format will necessarily survive forever.

McKinsey: *Say more about e-commerce moving from a national to an international business. What are some things Amazon China is doing on that front?*

Doug Gurr: Our primary focus is on cross-border e-commerce. We already do a pretty good job of helping Chinese businesses sell around the world; we want to do an equally good job of helping Western and Japanese businesses meet the growing demand from Chinese consumers for high-quality, authentic international products. We know the demand is there and that many international brands would love to sell in China but find it challenging to navigate the Chinese e-commerce landscape. To that end, we've launched a number of new services. One is the Amazon Global Store. We provide translation,

listing, regulatory compliance, local-language customer support, local marketing, global logistics, and so on, so that brands can launch in China with no more effort than selling in their local market.

In just six months we've been able to launch over three million unique products for our brands, with no cost or effort on their part—literally with the click of a button. We're rapidly expanding this and other services, and we're starting to explore partnerships with many brands—US, European, and Japanese—that are interested in the complex but compelling opportunity presented by the Chinese consumer.

McKinsey: *What role do you think robotics, automation, and technology in general will play in the future of the retail industry?*

Doug Gurr: It's transformative. You can take a view of retail organizations as decision-making machines. We have to make hundreds of millions, even billions, of decisions every day. How much do I price? Is this product safe? How much inventory should I hold at a particular location, at a particular store, at a particular moment of time? When should I replenish?

You read a lot about whether machines are better at making decisions than people are. I think it's kind of irrelevant unless the machines are materially worse at it, which they're not. The point of giving the decisions to machines is that you have scale. If you put human beings in the middle of every decision, you slow down. I used to work for a physical grocer, and every morning we'd argue about how much bananas were going to be that week. Today, it's unimaginable for me to spend time setting prices.

Retailers need to understand a whole bunch of new tools and technologies. Of course, they're not perfect; we're at an early stage of these

Doug Gurr



Vital statistics

Born in Leeds, United Kingdom

Married, with 2 children

Education

Holds bachelor's and master's degrees in mathematics from University of Cambridge

Holds a PhD in theoretical computing from University of Edinburgh

Career highlights

Amazon

(2014–present)

President, Amazon China

(2011–14)

Vice president

Asda

(2006–11)

Executive development director

Blueheath

(2001–06)

CEO

McKinsey

(1995–2001)

Partner

Fast facts

Speaks French and elementary Mandarin

Served as chairman (2010–14) and member (2003–10) of board of trustees of Science Museum in London

Is chairman-elect of British Heart Foundation

Has completed 12 Ironman triathlons

technologies. For example, we've all received those personalized marketing e-mails that aren't quite right: "My dog died, so don't send me e-mails promoting dog food." Or, "I already bought a TV; please stop telling me to buy another one." There's a lot of clunkiness because we've only been in this game for a few years and we're not yet very good at it. But personalization is so powerful that even at this early stage, if you compare a machine-based process with a pretty refined state-of-the-art manual process, technology wins every single time—and not by a slim margin.

I like to say that the only things people should do are things that only people can do—that is, making complex decisions that can't be automated because they're high uncertainty, they're hard to reverse, there's not enough data, or they're judgment calls. That does two things for you. First, it allows decision making at genuine scale. Second, it makes jobs more interesting for people.

My personal view is that the transformative technology of the early 21st century will

be data informatics, and I think it will happen much faster than most people assume. It's a classic distinctive capability. I think in ten years' time, in any business sector, the performance gap between an organization that invests in data informatics and one that doesn't will be huge. I would argue that the performance gap is already substantial, and it's only going to get bigger. ■

James Naylor is a senior expert in McKinsey's London office.

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Winning in Africa's consumer market

For consumer-goods companies, Africa holds much promise—but also many pitfalls. To succeed on the continent, companies must learn from the failures and successes of others.

Yaw Agyenim-Boateng, Richard Benson-Armer, and Bill Russo

Over the past few years, business leaders and investors have become increasingly aware of the vast potential in Africa's burgeoning consumer market. The continent, now home to more than 1.1 billion people, will account for one-fifth of the world's population by 2025. More and more Africans are entering the consumer class, with tens of millions emerging from poverty in recent years.

Yet there are well-known deterrents to doing business in Africa—political instability and poor infrastructure, to name just two—that can make companies hesitant to enter the market at all. That said, a few multinational consumer-packaged-goods (CPG) companies have managed to make important inroads in Africa. Their experience holds valuable lessons for others aspiring to capture the opportunities in one of the world's fastest-growing consumer markets.

Young, urban, connected

The working-age population in Africa is growing at a clip of 2.7 percent each year (compared with 1.3 percent in Latin America and 1.2 percent in Southeast Asia).

By 2025, nearly two-thirds of the estimated 303 million African households will have discretionary income. This massive expansion of the consumer pool—an addition of almost 90 million consumers in just ten years—will help fuel the continent's GDP growth from 4.9 percent today to 6.2 percent in the next decade, far outpacing the global GDP growth rate of 3.7 percent.¹

What's more, African consumers are young and willing to spend. Fifty-three percent of income earners in Africa are between 16 and 34 years old—an age group that tends to be more aware of and eager to try new products. These consumers will contribute to more than \$400 billion in total consumption growth in the next decade.

Driving this rapid growth are two trends that will continue to have a tremendous impact on Africa's consumer market: urbanization and the rise of mobile communications. By 2025, almost half of Africans will be living in cities. Africa already has as many cities with more than one million inhabitants as

North America does (Exhibit 1). In the largest African cities, consumption growth can rival even that of major cities in Brazil, Russia, India, or China: for example, between 2010 and 2020, incremental growth in food and beverage sales in Cairo will total approximately \$3.9 billion, compared with \$3.7 billion in Brasília and \$3.3 billion in Delhi. This concentration of consumers bodes well for CPG companies that can secure distribution in these fast-growing cities.

Mobile technology is also changing the game. Mobile penetration in Africa, estimated at 89 percent at the end of 2014,² is nevertheless growing fast and enabling transactions such as money transfers and microfinance. Kenya’s mobile-payments platforms, for instance, handled more than \$2 billion per month in transactions in 2013.

The challenges

But just as the potential of Africa has been widely acknowledged, so too have the perils of doing business there. Despite recent progress, several hurdles remain.

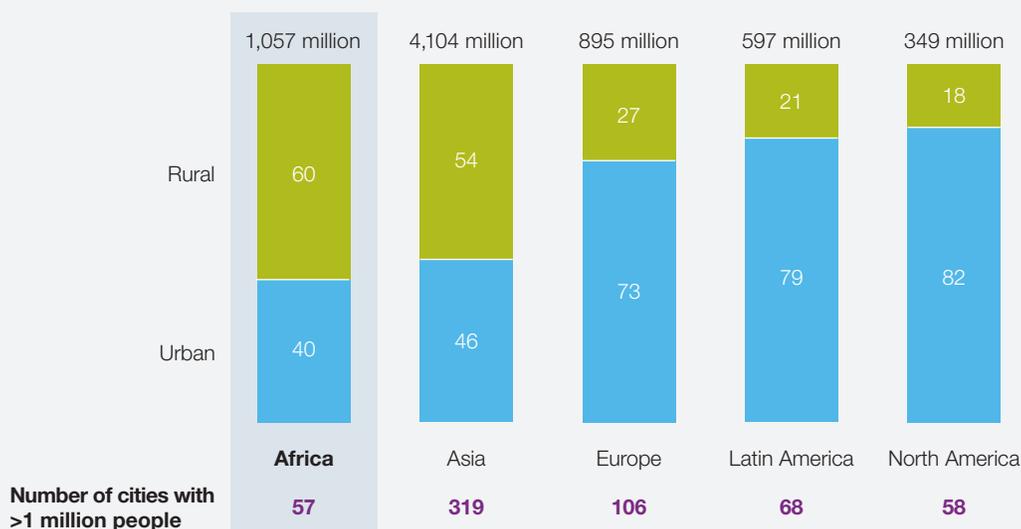
Political instability and conflict. Wars and authoritarian governments continue to adversely affect business and policy in many countries. According to world freedom indexes, which measure political and civil liberties, of 54 African nations only 10 are considered free, 22 are considered partially free, and 22 are considered not free.³

Poor infrastructure. Although many African cities now have modern road systems, only about one-third of Africans live within two kilometers of a paved road that is usable year-round.⁴ Travel within the continent is prohibitively expensive and difficult, with transportation costs five to eight times that in markets such as Brazil or Vietnam. About 70 percent of the population has no access to electricity. These problems constrain not just consumer demand but supply as well; ports in many African nations are characterized by capacity issues and high costs.

Exhibit 1

Africa has as many cities of at least one million people as North America.

Share of rural vs urban population by region, 2012, %



Source: United Nations; McKinsey Global Institute

Linguistic diversity. To communicate effectively with African consumers, companies need to deliver their marketing messages in a plethora of languages. South Africa has 11 official languages. Nigeria has only 1—English—but Nigerians speak more than 500 local languages. Further complicating consumer communications is the continent’s low literacy rate of 62 percent. In some countries, including Burkina Faso and Niger, the literacy rate is below 30 percent.

Differences in consumer behavior. Not only do Africans in different countries speak different languages; they also make buying decisions differently. Take price sensitivity, for example: most Angolans look at advertisements and comparison shop to get the best prices, but only 27 percent of Kenyans do the same. Opinions about brands differ by country and region as well.⁵

A fragmented retail market. Africans buy groceries primarily from neighborhood kiosks or independently owned convenience stores; in many countries, the percentage of groceries bought in supermarkets is in the low single digits. An exception is South Africa, where supermarkets account for an estimated 75 percent of grocery sales.⁶

Low data availability and quality. Historically, there’s been a dearth of economic data and market research about most parts of the continent except for the largest cities. Companies sometimes extrapolate existing data on big cities to the national or regional level, but such an exercise only yields inaccurate insights.

Lessons learned

In spite of these serious challenges, pioneering companies have been able to make Africa a part of their success story. More than 400 companies generate at least \$1 billion in Africa-based revenues. Coca-Cola, Nestlé, and Unilever, among others, have been on the continent for decades and enjoy significant market share in their categories; P&G has increased its African business more than tenfold

in the past ten years. In our experience, consumer companies that win in Africa are those that heed the following four imperatives.

Take a granular view of growth

The most successful entrants into Africa are those that have been careful and selective about the markets they enter. Instead of seeking to build a presence across entire countries, they’ve targeted the fastest-growing cities or city clusters—urban centers where per capita income and consumption spending far exceed the national average. Per capita income in Nairobi, for instance, is three times that in Kenya; Lagos residents on average earn twice as much as Nigerians overall. The capital city of Luanda accounts for 45 percent of total consumption in Angola. In 2025, almost 60 percent of consumption spending in Africa will come from the 20 largest cities.

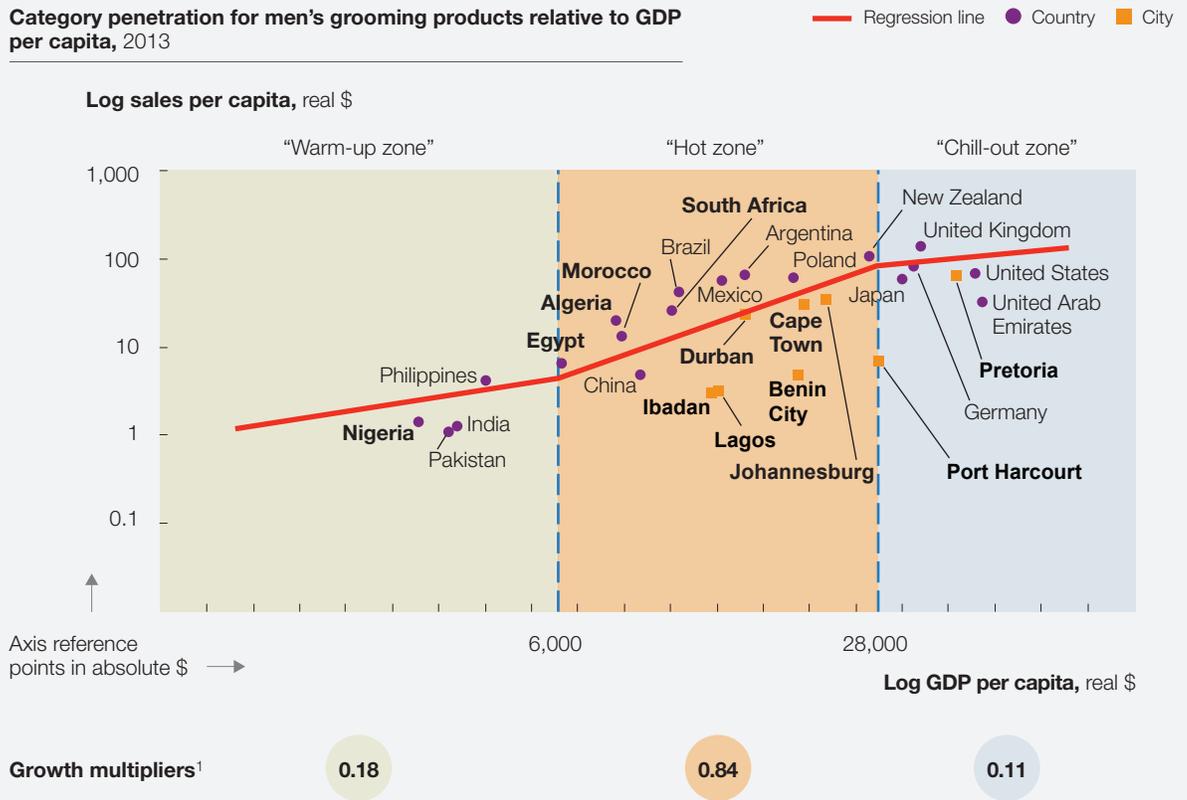
A city-based strategy is essential in Africa, given the rapid pace of urbanization and the differences in growth rates even among cities within the same country. But choosing the highest-potential cities is just one part of the puzzle; getting the timing right is another. Leading companies develop fact-based forecasts of the readiness of markets for specific product categories.

Consumer demand for a particular product or category typically follows an S-curve, with per capita income as the main variable. Exhibit 2 shows that men’s grooming products (such as razors and blades), for instance, are already in the “hot zone”—where penetration growth accelerates significantly—in many African cities. To be able to predict when consumer demand for a category will take off, a company must have a granular understanding of economic indicators, local-market trends, and statistical growth models.

A global packaged-food manufacturer started with a broad strategy but has since narrowed its focus to 15 cities that collectively represent about 25 percent of the total growth in packaged-food sales expected

Exhibit 2 Some African cities are already in the ‘hot zone’ for certain consumer-goods categories.

Category penetration for men’s grooming products relative to GDP per capita, 2013



¹Average % increase in category penetration from a 1% increase in GDP per capita, corrected for country fixed effects.
Source: McKinsey analysis

across Africa in the next five years. The company analyzed several subcategories and found, for example, that in nonalcoholic beverages, ten cities in five countries will contribute 25 percent of total growth, while in the dairy category, ten cities in six countries will contribute 23 percent of the growth. Such insights enabled the company to allocate resources to the most promising opportunities.

Tailor the offer to local needs and preferences

Companies must seek to understand local needs and preferences that drive mass adoption of their products, then tailor their offers accordingly. P&G changed the formulation of its Ariel detergent in Nigeria to make it lather faster and with less water, having discovered that Nigerian consumers see

lather as an indicator of a detergent’s quality and effectiveness. SABMiller created a beer specifically for Onitsha, a large commercial city in southeastern Nigeria, and gave it a local identity; the beer’s label features a rising sun, a cultural symbol of Onitsha’s Igbo people. The beer is less bitter than typical European lagers, making it better suited for drinking in hot weather. In Zambia, SABMiller’s brand is Mosi (which is what Zambians call Victoria Falls), with a label that shows the waterfall.⁷

Consumer companies must become aware of not only local product preferences but also local buying behaviors. For example, we found that in Lagos and Luanda, consumers perceive low-priced food items to be of questionable quality, whereas

consumers in Abuja, Accra, and Nairobi don't share the same perception and thus wouldn't hesitate to buy discounted food. In-country teams, tasked with gathering consumer insights and conducting pilots and concept tests, are crucial to CPG companies' success in local markets.

So, too, is designing a brand-pack-price architecture that covers all the different tiers in a market, from low end to premium. A company might introduce smaller packs or new pack configurations (such as shampoo in sachets) at price points that can attract the lowest-income consumers. But, particularly in categories where brand consciousness is high, it's also important to offer "aspirational" products—premium brands with recognizable packaging—at price points well within the reach of Africa's rising middle class.

In addition, CPG players can learn from—and perhaps even partner with—homegrown businesses that have tailored their offers to African consumers. Nigerian e-commerce pioneer Konga, for instance, established pickup locations and a "pay on delivery" service to address Nigerians' concerns about disclosing their home address or paying online.

[Create a bespoke route-to-market model by geography and channel](#)

Once a company has prioritized the highest-growth cities and defined a portfolio of products for them, it must then make sure that the products are available for sale in those cities. Effective distribution is the single most important determinant of success in African consumer markets.

The fragmented retail and wholesale landscape means that, in most African countries, there's no ready-made national—or even regional—network of distributors. Winners develop a route-to-market model that focuses first on the most attractive channels. In Ghana, for instance, CPG companies don't need their products to be on supermarket shelves; the most pervasive and

fastest-growing retail outlets are open-market stands and neighborhood kiosks. A confectionery manufacturer mapped those outlets in Ghana's largest cities, segmented them by sales volume, and tailored a route-to-market model for each segment: for example, small neighborhood kiosks would receive deliveries six times a week via a distributor's motorized tricycles, whereas larger kiosks would receive van deliveries three times a week, plus a visit every two weeks from a sales representative who would provide merchandising support and advice.

Winners forge strong relationships with carefully chosen trade partners. Companies would do well to select distribution partners that have sufficient scale—that is, partners that earn economic returns at least ten percentage points above the prevailing rates for borrowing in the market—to increase their chances of having a long-standing and stable partnership, as smaller players typically struggle to maintain cash flows and may not stay in business for long. And to guarantee enough attention from a distribution partner, a company should aim to represent at least 25 percent of that partner's profits. Product or category exclusivity is, of course, preferred but certainly not required. More important than exclusivity are trade terms that reward growth and sell-through of products.

Diageo, the global alcoholic-beverages company, launched its ambitious "Route to Consumer" program in 2013, with the goals of expanding distribution and driving activation in retail outlets around the world. In Nigeria's southern states, for example, Diageo is expanding coverage from 8,000 outlets to many more of the 45,000 outlets it identified in a recent market census. The company has begun zeroing in on the outlets it can serve profitably and plans to ramp up its sales force accordingly. In a similar effort under way in Ghana, Diageo has expanded its coverage by 20 percent and added more than 140 people to its sales force.⁸

Build a large, well-equipped sales force

Indeed, one common mistake companies make is to underestimate the size of the sales force they will need in Africa. The high degree of retail fragmentation means consumer companies must employ large armies of salespeople—many more than they are accustomed to having in developed markets—to form and nurture relationships with thousands (or tens of thousands) of small retail outlets.

The most successful companies emphasize both capability building and performance management for their sales force. For instance, they provide detailed sales training and guidance, breaking down the discrete activities each salesperson is expected to do during sales visits and creating simple routines to follow. They rigorously track metrics such as the productive-call ratio (the percentage of sales calls that result in the customer placing an order), effective distribution (typically measured as listings minus out-of-stocks), and sell-through rates. A few consumer companies—including British American Tobacco, Coca-Cola, and SABMiller—have built a reputation for developing the skills of their local African sales teams.

Winners also invest in technologies and solutions that allow their sales force not only to serve customers better but also to collect the data that are so scarce in most African markets. For example, Cadbury gives its more than 1,400 South African salespeople handheld devices that allow them to check inventory and pricing, place orders, and process invoices in a matter of seconds. Heineken's sales representatives in Africa can use their company-issued tablets to access up-to-date account data, map out and schedule their sales visits, and take photographs of displays in retail outlets.



Consumer companies seeking a foothold in Africa must be prepared to invest for the long haul. It will, no doubt, be a challenging and sometimes frustrating journey. But the payoff will be well worth it: African consumers reward brands they trust, and a brand that wins them over can thrive in the market for decades to come. ■

¹ *African Economic Outlook 2014: Global Value Chains and Africa's Industrialisation*, a joint report from the African Development Bank Group, Organisation for Economic Co-operation and Development, and United Nations Development Programme, May 2014, afdb.org.

² Analysis based on mobile-penetration data from Analysys Mason, BMI Research, and Yankee Group.

³ *Freedom in the World 2014: The Democratic Leadership Gap*, Freedom House, January 2014, freedomhouse.org.

⁴ "Better access to roads in rural areas is critical to raising agricultural productivity," Africa Infrastructure Knowledge Program, African Development Bank Group, infrastructureafrica.org.

⁵ For more on these country and regional differences, see *The rise of the African consumer: A report from McKinsey's Africa Consumer Insights Center*, October 2012, on mckinsey.com.

⁶ Canback Global Income Distribution Database, cgidd.com; Passport, Euromonitor International, euromonitor.com.

⁷ "The beer frontier," *Economist*, May 31, 2014, economist.com.

⁸ "Route to Consumer" webcasts, Diageo, November 5, 2014, and September 17, 2013, diageo.com.

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East Africa: The next hub for apparel sourcing?

East African countries—in particular, Ethiopia and Kenya—have the potential to become bigger players in garment manufacturing. But the road ahead won't be easy.

Achim Berg, Saskia Hedrich, and Bill Russo

In the past two years, a number of European companies—among them, H&M, Primark, and Tesco—began sourcing some of their garments from Ethiopia. The rest of the apparel industry took notice: since 2013, there has been rising interest in not just Ethiopia but also other East African countries as potential sourcing destinations for apparel. Also contributing to the buzz is the renewal of the African Growth and Opportunity Act (AGOA), which gives certain countries in sub-Saharan Africa duty-free access to the US market.

What is the true potential of East Africa to grow into a major garment-sourcing hub? To find out, we visited factories in the region; interviewed stakeholders, including manufacturers and buyers; and analyzed market data. In addition, we conducted our third survey of chief purchasing officers (CPOs), this time with a series of questions focused on East Africa. This year, 40 apparel CPOs, representing a combined \$70 billion in 2014 purchasing volume, responded to our survey. We found that East Africa could indeed become a more important center for apparel sourcing, but only if stakeholders—buyers, governments, and manufacturers—work together to improve business conditions in the region.

Up-and-coming sourcing countries

Nearly three-quarters of survey respondents said, as they did in 2011 and 2013, that over the next five years they expect to reduce their purchases from Chinese firms. Chinese apparel production has

indeed fallen since 2010—but China remains the undisputed giant of garment manufacturing, with approximately \$177 billion in apparel exports in 2013.

Among CPOs surveyed, Bangladesh remains at the top of the list of future sourcing destinations, with 48 percent of respondents including the country in their top three (Exhibit 1). And 62 percent said they intend to increase their sourcing value from Bangladesh over the next five years. The next two up-and-coming countries are Vietnam and India, where, respectively, 59 percent and 54 percent of surveyed CPOs plan to increase their sourcing value in the next five years. Yet the combined apparel exports of Bangladesh (\$24 billion), Vietnam (\$17 billion), and India (\$17 billion) still amount to less than one-third of China's.

For the first time in our survey, African nations appear on the list of countries expected to play more important roles in apparel manufacturing. Ethiopia, notably, is seventh on the list.

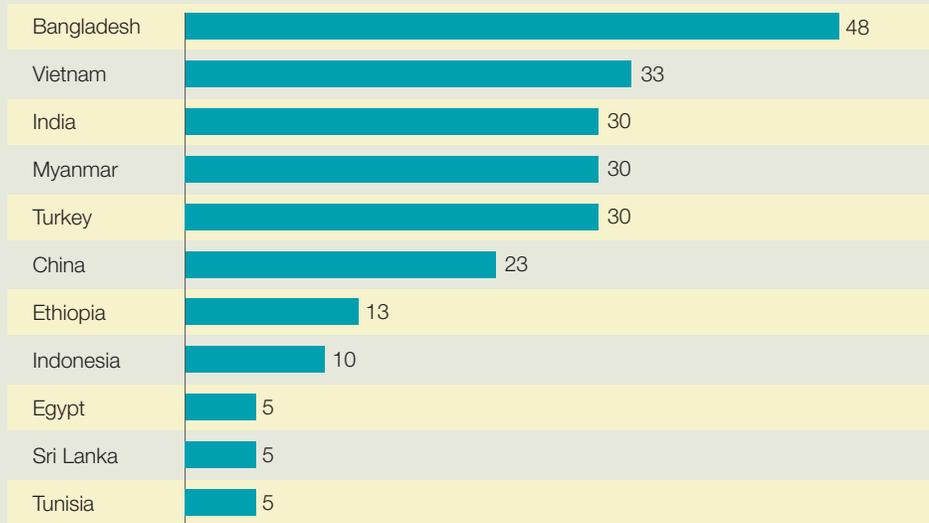
The East Africa opportunity

According to United Nations projections, sub-Saharan Africa will have the highest growth in working-age population anywhere over the next 20 years. By 2035, the working-age population in the region is expected to be as large as China's today—more than 900 million people. This massive labor pool is capturing the attention of several industries, including apparel.

Exhibit 1 Bangladesh remains the top future sourcing location; Ethiopia appears on the list for the first time.

“What will be the top 3 sourcing destinations over the next 5 years?”

Respondents who ranked the respective countries within the top 3, n = 40, %



Source: McKinsey survey of chief procurement officers, Jan/Feb 2015

Within sub-Saharan Africa, East African countries—especially Ethiopia and Kenya, and to a lesser extent Uganda and Tanzania—are of interest to apparel buyers (Exhibit 2). The governments of both Ethiopia and Kenya are taking steps to develop their domestic textile and garment industries.

Each of the two countries has strengths and weaknesses. Our research and interviews revealed, for example, that Ethiopia has cost advantages, whereas Kenya boasts higher production efficiency. Challenges common to both countries include poor infrastructure, cumbersome customs processes, a dearth of technical and managerial talent, and low levels of social and environmental compliance.

Ethiopia

Apparel buyers today are sourcing basic, large-volume items from Ethiopia: T-shirts accounted

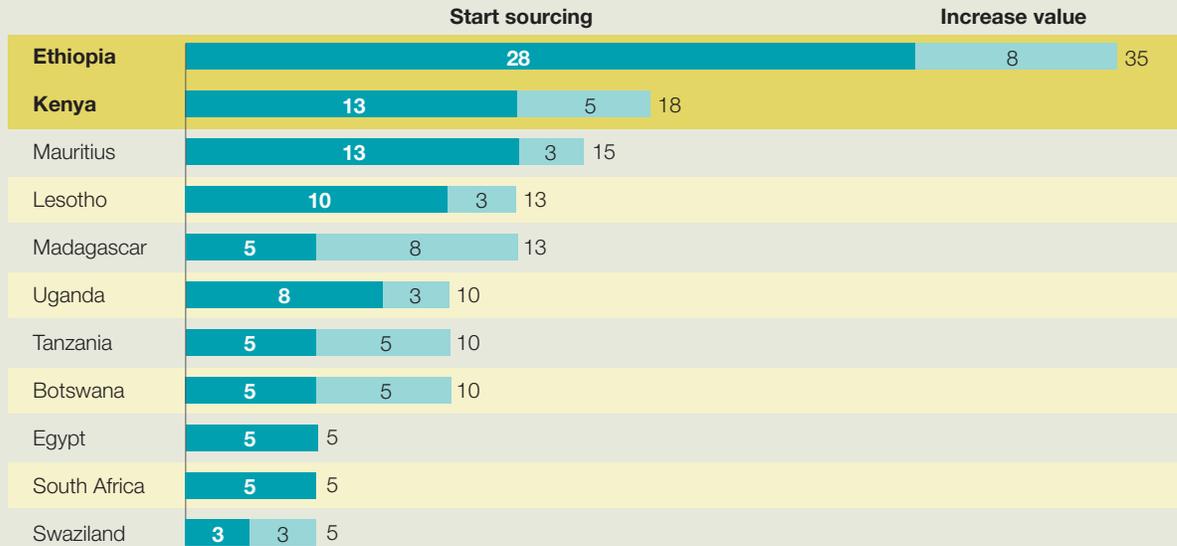
for 46 percent of the country’s exports to the EU-15 and trousers 31 percent. As much as 60 percent of exports are sent to Germany and 10 percent to the United States. But Ethiopia accounts for a mere 0.01 percent of total apparel exports, according to the World Trade Organization.

Why, then, is Ethiopia such a hot topic for apparel buyers? Our interviewees and survey respondents said the biggest reason is cost: Ethiopia’s wages for garment workers are among the lowest globally, at below \$60 per month, and work-permit costs for foreign workers are less than one-tenth those in neighboring Kenya. Additionally, Ethiopia has low electricity prices. The country has a strong supply of hydroelectric power, and while the power grid is not the most reliable, the Ethiopian government is building a separate grid for new industrial zones currently under development.

Exhibit 2 Among sub-Saharan African countries, Ethiopia and Kenya are of greatest interest to global buyers.

“Do you expect to either start or increase sourcing from these countries between now and 2020?”

Respondents, n = 40, %¹



¹ Figures may not sum, because of rounding.

Source: McKinsey survey of chief procurement officers, Jan/Feb 2015

Ethiopia could someday become a source of raw materials: it has more than 3.2 million hectares of land with a suitable climate for cotton cultivation. Yet barely 7 percent of that land is being used today. The combination of low land-utilization rates, planning errors, low crop yields, and quality problems means Ethiopia has had to import cotton. Social compliance has also been an issue. For example, organic-cotton cultivation recently suffered a setback after garment manufacturers supplying European firms became entangled in land-grabbing accusations in Ethiopia’s Omo Valley.

Another problem is production efficiency, which currently runs between 40 and 50 percent, and long lead times. Eighty percent of the CPOs in our survey cited production inefficiency as a challenge to the growth of apparel sourcing in Ethiopia.

Kenya

Like Ethiopia’s, Kenya’s apparel industry currently specializes in supplying high-volume bulk basics such as trousers, which account for 58 percent of its exports to the United States. The typical minimum order size is 10,000 pieces; the country’s larger players have minimum order sizes of 25,000 to 50,000 pieces.

Kenya has benefited greatly from AGOA—92 percent of its apparel exports in 2013 went to the United States, according to UN Comtrade. Suppliers we interviewed said the EU’s Economic Partnership Agreement isn’t as much of an incentive: the overall duty-free advantage is less than that of AGOA, and the competition with low-cost Asian countries is stiff, as they too are benefiting from preferential agreements with the European Union. Some Kenyan

manufacturers said they aren't eager to expand their business to Europe because they perceive European buyers as more demanding with respect to lead times, order sizes, and quality.

The capacity of Kenya's garment factories has grown markedly in recent years, thanks to foreign direct investments from Asia and the Middle East, as well as support from the export processing zones developed by the Kenyan government. Factories have grown larger and more efficient; they now have around 1,500 employees on average, compared with around 560 in the year 2000.

However, as a result of the lack of a local upstream industry, manufacturers must import fabrics—which means considerably longer lead times. Fabrics from overseas can take up to 40 days to make their way through customs and to a garment factory. Manufacturers and buyers alike said that another challenge of doing business in Kenya is comparatively high labor costs, with monthly wages for garment workers in the \$120 to \$150

range. Energy costs are also high, and because the power supply is spotty, factories often have to rely on generators. In Africa, power from generators works out to be four times as expensive as power from the grid.¹

Like Ethiopia, Kenya will need to address compliance and risk issues if it is to attract more international buyers. According to the CPOs we surveyed, corruption, high crime rates, and poor social compliance are among the core challenges they face in Kenya.

Future scenarios for East Africa

As part of our analysis, we created, tested, and refined three scenarios for the evolution of East Africa—in particular, Ethiopia, Kenya, Tanzania, and Uganda—over the next decade (Exhibit 3). In 2013, these four countries' apparel exports totaled \$337 million.

The first scenario is that East Africa will remain a niche market. This scenario assumes that free-trade agreements with the United States and the European Union will continue.

Exhibit 3 We see three scenarios for the future of East Africa as a sourcing hub.



Source: McKinsey analysis

If East Africa is to experience sustainable growth in garment manufacturing, collaboration among all stakeholders is a must.



In part as a result of volatility in currencies and equity markets, the prospects for the region will remain rather modest.

In the second scenario, East Africa becomes a new sourcing option for several large players in the basics categories, and the region's apparel exports more than double. In this scenario, East Africa's garment companies move beyond cut, make, and trim facilities² and embark on the path to vertical integration—but this process could take several years.

A third scenario assumes that major apparel companies from around the world begin to open sourcing offices in East Africa. The region attracts enough investment to upgrade facilities and recruit skilled workers, and its export volumes approach those of countries such as Mexico or Pakistan. But even in this scenario, it could take years for vertically integrated, indigenous players to appear in the region—and that might be achievable only if the countries cooperate to build regional value chains.



If East Africa is to experience sustainable growth in garment manufacturing, collaboration among all stakeholders is a must. Governments, for instance, might consider whether to invest in infrastructure, support local entrepreneurs, diversify free-trade agreements, and build market-oriented educational institutions. Suppliers will need to embrace performance improvements and management training, upgrade their facilities and offerings, and enter into long-term partnerships with buyers. All parties will need to make every effort to ensure social and environmental compliance. Buyers, for their part, would do well to support the capability-building efforts of East African suppliers and begin to evaluate the region as a true strategic option rather than just a testing ground. ■

¹ Antonio Castellano, Adam Kendall, Mikhail Nikomarov, and Tarryn Swemmer, *Brighter Africa: The growth potential of the sub-Saharan electricity sector*, McKinsey & Company, February 2015, mckinsey.com.

² Cut, make, and trim (CMT) factories do not supply fabrics. Apparel buyers must select and buy all the fabric, trimmings, and other components. Workers at the CMT factories then use those fabrics to make the garments.

This article is adapted from *Sourcing in a volatile world: The East Africa opportunity*, an April 2015 report from the Apparel, Fashion & Luxury Group in McKinsey's Retail Practice.

The authors wish to thank Benedikt Berlemann for his contributions to this article.

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Becoming a regional powerhouse in food retailing

Croatian conglomerate Agrokor is the top grocery player in five countries. In this interview, the company's head of retail reflects on the rewards and challenges of cross-border growth.

Tobias Wachinger

Agrokor is Croatia's largest private company and one of Europe's largest family-owned businesses. It has a presence in several industries, including agriculture, food production, grocery and nonfood retail, and tourism. Having acquired Slovenian grocer Mercator in 2014, Agrokor now operates a €6 billion retail business with approximately 2,000 stores across five countries in southeastern Europe.

Overseeing Agrokor's retail interests is Ante Todorčić, who was groomed for the job from a young age—after all, it was his father, Agrokor president Ivica Todorčić, who started the company as a small business selling flowers and seedlings in 1976. Ante Todorčić joined the company in 2006 and is now the executive vice president in charge of its retail business.

In July, he sat down with McKinsey's Tobias Wachinger and shared his thoughts on Agrokor's recent growth.

McKinsey: *Agrokor roughly doubled the size of its retail business after acquiring Mercator. Had you been planning that deal for a long time?*

Ante Todorčić: Yes, we'd been thinking about the merger for many years. Let me give you a little bit of company history: in 1994, Agrokor acquired the Croatian grocery retailer Konzum, which was a €300 million business with 200 stores in Zagreb. Over the past 20 years, Konzum's revenues have multiplied tenfold. As of last summer, Konzum was a €3 billion business operating about 1,000 stores in three countries: Croatia, Bosnia and Herzegovina, and Serbia. As we were going on this expansion journey, we realized that we have a good retail formula—we know how to build successful stores in which customers like to do their grocery shopping.

So, as far back as nine years ago, we began discussing the possibility of merging with

Mercator, our main competitor, and thereby becoming the largest retailer in the region. Mercator's supermarket format was comparable to Konzum's and it was, like Konzum, highly appreciated and highly rated by customers. But its footprint was a little different, which made it an attractive target for us: Mercator was big in Slovenia and Montenegro, where Konzum didn't have a presence. Mercator had opened some stores in Croatia and Bosnia and Herzegovina, where Konzum was already the clear retail leader. In Serbia, Konzum and Mercator had businesses of similar size.

In the past three years, we did a lot of work to finalize the acquisition. It was a complicated process, but we finally closed the deal in September 2014. We're now the proud owner of Mercator. And we've become the market leader in all five of these countries, as well as the leading retailer in the Adria region.

McKinsey: *It's now been almost a year. Has the acquisition met your expectations?*

Ante Todorčić: Absolutely. We are seeing improvements in the business and leveraging substantial synergies, which justify the big investment we made. We're convinced that the acquisition was the right move. But I must say that the work has not become less intense—rather, it's the opposite.

McKinsey: *Say more about that. What aspects of the integration have required intense work?*

Ante Todorčić: We were well prepared before we closed the deal; hundreds of colleagues on both sides had prepared for the integration. Since September 2014, we've become even more structured and disciplined. We set up cross-country projects for all key retail functions—from purchasing, assortment, and private label to store operations, logistics, utilities, and IT. For each of these, we have a clear plan and well-defined targets

for improvement. Everyone understands their responsibilities, both within each country and for the overall company. We meticulously monitor these projects to ensure that they deliver. And that is hard work: it means tracking the implementation of each of the improvement ideas and providing support whenever it is needed.

Of course, the success of these postmerger projects is the top priority for all managers. For the past year, we—the retail managers of Agrokor and Mercator, the country managers, and key functional managers in critical departments such as purchasing and HR—have sat together for an entire day every week to make sure that we develop the right strategy and the right solutions for whatever issues arise.

In doing all this, we're taking advantage of the fact that both Konzum and Mercator have invested immensely over the past few years in learning how to run an excellent retail chain. Each of the countries is good at something and serves as a benchmark for the other countries to follow. We've also benchmarked ourselves against European best-practice retailers in areas such as loyalty-program design and private label, and we've tried to make our benchmarking as detailed as possible. We've talked to countless experts.

We've done all this because we want to excel. I firmly believe that we will succeed in the long run only if we can deliver the best offer to our customers while also having the most efficient cost base.

McKinsey: *It sounds like you're focused on not just merger-related synergies but more broadly on best-practice transfer across all the countries in which you operate.*

Ante Todorčić: Yes, exactly. It doesn't really matter to us where an idea for improvement comes from or whether it's related to scale or to synergies. We want to become better and better, and to do that we need to pursue all avenues for improvement potential.

Ante Todorčić



Vital statistics

Born in 1978 in Zagreb, Croatia

Married, with 3 children

Education

Holds a BS in economics from the University of Zagreb

Career highlights

Agrokor Group

(2008–present)

Executive vice president, retail business group

Chairman of the supervisory board of Frikom, a Serbian manufacturer and distributor of ice cream and frozen food

Former deputy chairman of the supervisory board of PIK Vinkovci, an agriculture and transportation company

Former member of the supervisory board of Zvijezda, Croatia's largest producer of edible oils

McKinsey: *You now have stores in five countries from the former Yugoslavia. These countries share a difficult past. Was it challenging to bring the various countries' management teams together and get them to all go in the same direction?*

Ante Todorčić: It was—and continues to be—a major challenge, for sure. Our countries are very different, not just in culture and mentality but also in economic terms. Slovenia, for example, is at a completely different level of GDP per capita than, say, Bosnia or Montenegro. So of course we need to take into account that the cost structures of the countries are different and that retail prices are different. But taking such differences into consideration is something that every multicountry retailer needs to do. At its core, retail is a local business. We need to serve local customer needs, meet local assortment requirements, recognize local mentalities, and of course hold our own against local competitors.

What we want to achieve is the right mix—the perfect balance of getting everyone to march in one direction

toward best practice and of maintaining the local spirit of the countries. Therefore, we constantly need to question whether that one direction is the right one in a specific market. We always need to make sure that we have great local leaders in each country who understand how best to be competitive in that country. I believe we've come to some good decisions in each country.

There are also significant differences in corporate culture. Mercator comes from a history of being a Slovenian state-owned company; Agrokor is a Croatian owner-led company. There are big differences in how people think about problems, how they deal with challenges, how much they rely on analytics, how they develop pragmatic solutions, and so on. We all need to bear in mind that there are fundamental differences that stem from each company's past. So far, I believe we have managed these differences successfully—by creating cross-country projects, by making sure that both sides are driving projects for synergy creation and best-practice exchange, and of course by having all top

managers from both sides take part in the frequent, long meetings I mentioned. We're proud that we've taken the best of both cultures and made it into a productive collaboration.

But I'm aware that we are not yet done with the integration. We need to always be careful to not take things for granted.

McKinsey: *You say you are not done yet. How long do you think it will take to fully integrate the companies?*

Ante Todoric: I think about this effort as having three layers. The first layer consists of the strategic pillars and decisions—regarding store formats, banners, assortments, and key processes—that we now have in place, for the most part. The second layer, the fine-tuning, will take another two or three years, and we will be in even better shape after that's done. Then there is a third layer, made up of the things that will need to stay local and might never be fully integrated.

Our work is already paying off—this year we will see good results, and next year we hope to see even better results. But we are a company that never stops. We're always looking for the next things to work on and improve: how we present fresh products in the stores, how to optimize promotions, and so on.

McKinsey: *Do you think this acquisition and the integration have changed the way you lead?*

Ante Todoric: This merger was one of the biggest business transactions in the history of our region. I believe everyone who has been involved in such an effort should be thankful. It has been a huge learning experience for me. We touched so many levers. I saw—and am seeing—so many different business practices across countries and stores, and I deal with so many different managers from different cultures. I feel much stronger and more confident as a leader than I did even just a few years ago.

Despite the hard work, this effort is incredibly energizing. I am learning something new daily, and I have the pleasure to coordinate a group of excellent managers and experts. To be clear, this merger was possible only because we have strong leaders in all the countries. The success of a merger like this depends on the leaders who are driving it. I am grateful to have so many people I can rely on—and I do rely on their daily work, their ideas, their stamina, their desire to become better all the time. I am very proud to work with these people in such a culture and spirit. ■

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Secrets to implementation success

What do successful implementers do differently from other companies? Our survey of more than 2,200 executives yields actionable answers.

Frédéric Lefort, Dave McMurray, and Joseph Tesvic

Any executive who has led a major change program knows that even the most carefully planned programs can fail due to mediocre implementation. Turning plans into reality isn't easy, and certain companies just seem to be better at it than others. To learn how some of the world's leading companies ensure implementation excellence, we conducted a survey of more than 2,200 executives in 900 companies across industries.¹ We asked respondents to evaluate their company's implementation performance, capabilities, and practices.

Our survey revealed that "good implementers"—defined as companies whose respondents reported top-quartile scores for their implementation capabilities—also received higher scores on a range of financial-performance indexes relative to their competitors. Perhaps more important, good-implementer respondents say that two years after the change efforts ended, their companies sustained twice the financial benefits compared with change efforts at poor implementers.

So what can consumer-packaged-goods (CPG) companies learn from successful implementers?

The factors that matter most

Every company "leaks" value at various stages of the implementation process: some of the prioritized initiatives don't get implemented, others are implemented but don't achieve bottom-line impact, and still others may achieve bottom-line impact but can't sustain it. Good implementers retain more value at every stage of the process than poor implementers do (Exhibit 1).

Clearly, implementation is hard to get right. Less than half of respondents say that most or all of their change efforts in the past five years met their initial goals and sustained results over time.

The most crucial factors when it comes to implementation success or failure, according to survey respondents, are organization-wide ownership of and commitment to change,

Exhibit 1

The ‘good implementers’ retain more value than their peers at every stage of implementation.

Proportion of opportunities that good-implementer companies retain at each stage of implementation, relative to bottom-quartile companies



prioritization, and sufficient resources and capabilities (Exhibit 2). These factors are the top three for many industries, including CPG. Below, we discuss each of these factors in greater detail, citing examples of best practices that we’ve identified in our work with CPG companies worldwide.

Ownership and commitment

In our experience, one effective way to foster ownership and commitment is to create a project-management office (PMO): a formal entity directly responsible for leading the change effort and monitoring its progress. The PMO should be led by a relatively senior person who reports to a C-level executive—otherwise he or she won’t be taken seriously. Top management must view the role of PMO leader as an important stepping stone for a high performer; in other words, the PMO leader should be someone who is seen as a future C-level executive. Although the ideal PMO leader will be chosen from within the company (so that he or she will have more credibility in the organization), we’ve found that it’s more effective to bring in a skilled leader from outside rather than appoint an insider who doesn’t have the leadership skills to rally the troops.

The “troops” will almost always include staff from different functions. For instance, a sales transformation will most likely involve not just

salespeople but also employees in the marketing, finance, and product-development functions. At a large CPG manufacturer, a handpicked representative from every relevant function devoted 20 percent of his or her time to the PMO for 12 to 24 months and reported to the PMO leader as either a direct or dotted-line report. The entire team had joint goals related to the transformation, and these goals were linked to each team member’s performance appraisals and compensation.

The PMO should consist primarily of high-performing individuals, but it should also include up-and-comers who would benefit from the training and increased responsibilities. In addition, some companies deliberately assign to the PMO a few valued employees who are perceived as roadblocks—people who may initially be opposed to the transformation—to understand and address their concerns and eventually gain their support.

But ownership and commitment among the PMO staff won’t be enough; the rest of the company has to get on board as well. To that end, leaders should ensure that several critical elements are in place early on, including top-team alignment on the transformation’s “change story” and aspirations, specific targets for both performance and health across all the relevant business functions, and visible

Exhibit 2

Ownership of and commitment to change have the greatest bearing on a major change effort's outcome.

% of respondents,¹ n = 2,230



¹ Respondents who answered “don’t know” are not shown.

and committed leadership at all levels. Frequent and varied communication is essential.

When a leading breakfast-food manufacturer embarked on a large-scale transformation, executives kept all stakeholders informed about its progress using a range of written communications—e-mail updates, a new internal newsletter, intranet stories, webinars during which employees could ask questions anonymously—as well as in-person forums such as town halls and department meetings. The CEO kicked off the change program and, every six months, sent out a company-wide letter celebrating its achievements. In each of the company’s four

geographic regions, the senior executive directly in charge of the transformation held a town hall and fielded questions from employees. The PMO leader hosted open forums regularly and gave monthly progress updates either in person or in writing.

Prioritization of initiatives

Some transformation efforts flounder because too many initiatives are going on at once, spreading the organization’s resources too thin. To ensure that resources are efficiently and wisely allocated, leaders should assess each initiative’s alignment with the organization’s strategy and its potential impact, and prioritize accordingly.

A global food company took a phased approach to its procurement-transformation efforts, devoting the initial phase to a set of quick wins in order to build buy-in and momentum. For instance, for one of the company's key food ingredients, it had too many suppliers—eight, compared with three or four suppliers in other categories. Consolidation would increase the company's buying power and significantly lower its costs. Therefore, one of the early high-priority initiatives was to put all eight incumbent suppliers, along with a few new vendors, through a competitive bidding process. After three months, the company had four fewer suppliers, a more efficient supply base, and 10 percent cost savings in the category—demonstrating to the rest of the organization that the transformation effort was worthwhile and spurring the procurement teams in charge of other categories to reevaluate their supply base as well.

One common mistake companies make is to assume that certain changes simply can't be made—that a suboptimal multiyear contract with a supplier, for example, would be impossible to amend. But, in our experience, very few things are set in stone: the terms of an agreement can be renegotiated, contracts can be modified, and project timelines can be accelerated or lengthened. It may just take more energy and creativity to get to a win-win scenario, and the head of the PMO may need to forcefully make a case for change.

Another common mistake is to simply continue whatever initiatives happen to already be under way, even if they won't make as much of an impact as other initiatives. Companies should instead build a solid fact base, agree on an estimate of the "size of the prize," and focus on those initiatives that will yield the greatest payoff. If a company continues to commit resources to low-impact initiatives, the transformation effort will lose steam; resources will be squandered and opportunities lost.

[Resources and capabilities](#)

For consumer-facing companies, resources are a particularly important success factor: 43 percent

of respondents from such companies, compared with 34 percent of their B2B peers, attribute the success of change efforts to sufficient resources and capabilities. For failed efforts, half of B2C respondents say insufficient resources were to blame; just 40 percent of B2B executives say the same.

At the best implementers, change programs are staffed with the required number of people who have the relevant skill sets. Each person's role is well defined, and expectations and responsibilities are aligned with the resources available; employees' duties lie solidly within their areas of specialty or are appropriate for their skill levels. All employees receive feedback and ongoing coaching.

Sometimes, there are enough people working on a change program—but they don't have the requisite capabilities. At good-implementer companies, a rigorous capability-building component is central to the program and typically involves the creation and use of a detailed skill matrix to highlight skill gaps and training needs, stringent evaluation processes, and clear professional-development and career paths.

The food company undertaking a procurement transformation had multiple purchasing centers around the world. The purchasing staff used whatever category-management practices, processes, and tools they wanted, and the lack of standardization often resulted in wide variability in performance. So, as part of the transformation, the chief procurement officer designated a lead buyer for every category. The lead buyer was tasked with overseeing and training the buyers for that category in every region, ensuring that all the buyers across the company were using the same guidelines, tools, and metrics and aiming for the same targets. Even experienced buyers had to be retrained in some best-practice tools and techniques that they had either never learned to use or had stopped using in favor of easier but less robust methods. The capability-building

component honed the skills of all the company’s 80-plus procurement professionals.

With global category strategies in place and a central repository of best-in-class sourcing tools (such as supplier profiles, procurement playbooks, “clean sheets,” and requests for proposals) accessible to all buyers, the procurement organization was able to capture synergies and efficiencies in its tactical activities—freeing up staff to focus on more strategic initiatives. The impact was a 54 percent decline in costs compared with the previous four years.

Implementation practices

As for specific implementation practices, executives say their companies do fairly well at developing standard operating procedures and assessing employees against their individual goals. But they say their companies falter when it comes to conducting effective meetings, having processes in

place to identify problems, and giving employees effective feedback (Exhibit 3).

Often, it takes a radical decision to get to best practice. For example, a C-level officer at a large food distributor realized that the members of his buying staff were constantly in internal meetings and thus weren’t spending enough time on their core responsibilities. He took the bold step of discontinuing all routine departmental meetings, thus freeing up several hours of the buyers’ time each week. Instead, he required buyers to participate in detailed one-on-one sessions with him to discuss progress on specific initiatives. During these sessions, the executive gave each buyer direct and immediate feedback. Ultimately, the executive himself had many more weekly meetings than he previously had, but he—and the buying staff—agreed that these meetings were significantly more productive.

Exhibit 3 Companies are best at using standardized procedures and assessing employees; many lack effective problem-solving processes.

% of respondents,¹ n = 2,230

Strongly agree Somewhat agree Somewhat disagree Strongly disagree

Extent to which respondents agree that practices describe their organizations



¹ Respondents who answered “don’t know/not applicable” are not shown, so figures may not sum to 100%.



At top-quartile implementers, a higher proportion of experienced change leaders lead transformation programs relative to other companies. In fact, the survey respondents at good implementers were 1.4 times more likely than those at poor implementers to have personally led multiple change efforts. These findings are consistent with the belief, shared by the world's best implementers, that implementation is a discipline and that people can get better at it over time. Indeed, by learning from others' experiences and adopting their best practices, leaders at consumer-goods companies can better ensure implementation success. ■

¹ The online survey was in the field from January 14 to January 24, 2014, and garnered responses from 2,230 executives representing the full range of regions, industries, company sizes, functional specialties, and tenures. The results reported in this article also include responses from an additional 151 global executives surveyed at an earlier date. To adjust for differences in response rates, the data are weighted by the contribution of each respondent's nation to global GDP.

The authors wish to thank Jesse Scott for his contributions to this article.

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Getting the most out of your sustainability program

Sustainability initiatives won't create lasting value if they're poorly managed. Here are four lessons from companies that are doing it right.

Achim Berg, Nils Schlag, and Martin Stuchtey

Among retailers and consumer-goods manufacturers, commitment to environmental and social objectives can take many forms—whether it's distributing fair-trade products, reducing materials used in packaging, or ensuring humane working conditions at suppliers' factories. Unilever, for one, has a detailed Sustainable Living Plan, and among the company's goals for 2020 is to halve the greenhouse-gas impact of its products over their life cycles. Swedish furniture maker IKEA has installed more than 700,000 solar panels in its buildings worldwide and has committed to own and operate more than 300 wind turbines. British retail group Kingfisher's sustainability plan, which it calls Net Positive, aims not only to make frugal use of natural resources but also to restore and regenerate the environment—"putting back more than we take out," as the company says.

These programs can be powerful agents of change, both toward greater alignment between customer

and corporate interests and toward a culture of systemwide innovation in products and business models. Yet some skepticism remains as to whether sustainability efforts have any impact on financial performance in the short and medium term. Our recent research provides answers to both of these questions.¹ In this article, we discuss how companies are creating value from their sustainability programs and what practices enable companies to keep these programs running smoothly and effectively.

How sustainability programs create value

In previous work, our colleagues have outlined the various ways that companies can use sustainability initiatives to manage risk, drive growth, or improve returns on capital (Exhibit 1).² In our latest research, we sought to unearth examples of how companies are actually doing it. We found that companies that built sustainability into their operations saw immediate benefits, which gave them the momentum to do even more.

Exhibit 1 Companies are pursuing sustainability in a way that creates value.



Source: Sheila Bonini and Stephan Görner, "The business of sustainability: McKinsey Global Survey results," Oct 2011, mckinsey.com

Risk management

Of the companies we surveyed,³ more than 90 percent could point to a specific event or risk—such as consumer pressure or soaring commodity prices—that directly triggered their commitment to sustainability. More than half cited long-term risks to their businesses: 26 percent said they wanted to avoid damage to their reputations, 15 percent were seeking to prevent regulatory problems, and 15 percent said they wanted to eliminate unnecessary operational risks. Indeed, we found that the value at stake from risk-related sustainability issues can be as high as 70 percent of earnings before interest, taxes, depreciation, and amortization (Exhibit 2).

What do these risk-management efforts look like in practice? The US-based candy companies Mars and Hershey offer two examples. To secure their future supply of cocoa, both companies are investing in the sustainability of their suppliers. Mars supports smallholder cocoa farmers in Côte d'Ivoire by providing high-quality seeds and fertilizers as well as training; it is also investing in research to improve the quality and performance of cocoa plants. Hershey sends experts to teach its suppliers best-practice farming methods; its CocoaLink mobile-phone service offers advice and market information. The company also contributes to local education initiatives and the fight against child labor. Both companies have set a goal of having their entire cocoa supply sustainably sourced by 2020.

Exhibit 2

Our research shows that the value at stake from sustainability challenges is substantial.

Challenge	Examples	Potential impact, % of EBITDA ¹
Regulation/ reputation	Restricted license to operate Reputational damage based on perceived misuse of resources	70
Rising operating costs	Raw-material costs driven up by supply/demand True cost of water or carbon reflected in prices	60
Supply-chain disruption	Production delay or cancellation due to lack of access Especially significant for local resources—water, power	25

¹Earnings before interest, taxes, depreciation, and amortization.

Growth

Nearly half the companies we surveyed (44 percent) cited business and growth opportunities as the impetus for starting their sustainability programs. Redesigning products to make them more sustainable, for instance, can yield tremendous financial benefits. Unilever developed a brand of dishwashing liquid, Sunlight, that is equally effective but uses much less water than other brands; sales of Sunlight and Unilever’s other water-saving products are outpacing category growth by more than 20 percent in certain water-scarce markets.

Apparel companies such as Europe’s C&A now use organic cotton, which is grown without synthetic chemicals or genetically modified seeds. Consumer demand for organic cotton is rising: in 2014, C&A sold 130 million garments made from the fabric, up from 85 million in 2012. C&A plans to use organic cotton in 100 percent of its cotton products by 2020.

Returns on capital

Most of the companies we surveyed said their sustainability initiatives began with a focus on

reducing resource consumption: 97 percent of them are conducting initiatives to increase energy efficiency, 91 percent to reduce waste, and 85 percent to save water in day-to-day operations.

Puma, the sporting-goods manufacturer, has been measuring its ecological footprint and that of its largest suppliers since 2005. It aims to reduce the waste it generates, as well as its water and energy consumption and carbon dioxide emissions, by 25 percent compared with 2010. The company is making steady progress: between 2010 and 2013, Puma reduced waste generated per employee by 35 percent and cut energy consumption by 4.2 percent.

Bringing discipline to sustainability programs

Even with a sustainability agenda in place, companies often encounter problems with execution. To bring more discipline to their sustainability efforts, companies would do well to follow four principles commonly associated with performance management: select a few focus areas, set measurable goals, conduct cost-benefit analyses, and create incentives for employees and suppliers.

Companies would do well to follow four principles: select a few focus areas, set measurable goals, conduct cost-benefit analyses, and create incentives for employees and suppliers.



Focus, focus, focus

We found that many companies choose more than 10 areas in which to concentrate their sustainability efforts; some choose more than 30. It's hard to imagine how a sustainability agenda with such a large number of focus areas can get the necessary buy-in and resources to be successful. In our experience, the best approach for maximizing impact is to select three, or at most five, strategic priorities.

For example, Coca-Cola's sustainability framework—which it calls Me, We, World—encompasses its initiatives to improve personal health and wellness, the communities in which it operates, and the environment. The company reports making material, tangible progress on metrics related to three specific areas of focus within this framework: well-being, women, and water.

To emulate Coca-Cola's success in identifying focus areas that are a good fit with corporate strategy, a company should study what matters most along its entire value chain through internal analysis and dialogue with suppliers, customers, regulators, and nongovernmental organizations. The end product of these efforts shouldn't be a mere laundry list of vague ideas but rather a systematic sustainability agenda.

Set measurable goals

For each focus area, a company then needs to set clear, quantifiable goals with a long-term orientation (five years or more) and communicate those goals both internally and externally. Notice the difference between a general aspiration to “reduce the impact of our packaging on the environment” and a specific, measurable goal to “eliminate 20 million pounds of packaging by 2016.” Another example of a specific goal comes from a coalition of apparel retailers and

manufacturers including Benetton, H&M, Inditex, and Marks and Spencer: these companies are aiming for supply networks with zero discharge of hazardous chemicals by 2020.

Publicizing quantifiable goals motivates the organization, forces leaders to allocate resources, and promotes accountability. An analysis of companies that are part of the Carbon Disclosure Project found that those that announced their goals to the public did better when it came to cutting emissions—and also had better financial returns on such investments.

Conduct cost-benefit analyses and communicate the results

Making the business case for sustainability might sound like an obvious thing to do, but apparently it isn't. Only around a fifth of survey respondents reported that the financial benefits are clearly understood across the organization.

Many companies have struggled to quantify the financial impact of their social and environmental initiatives, in part because of the distributed nature of that impact: savings or profits arising from sustainability initiatives are commonly spread across various parts of an organization. It is therefore advisable to appoint an executive as

the “owner” of each target, meaning his or her team continually tracks the costs and benefits of sustainability actions. Tracking should also extend to indirect effects, such as an enhanced corporate reputation and increased customer loyalty, which pay off over the longer term.

Marks and Spencer tracks progress against its sustainability commitments, as laid out in the company's Plan A program. The commitments generated £145 million in net benefits in 2013–14. These benefits are regularly communicated to shareholders, employees, and consumers; for instance, the company's latest annual report mentions Plan A more than 70 times.

Create incentives for employees and suppliers

The top reason that survey respondents gave for their companies' failure to capture the full value of sustainability was the lack of incentives to do so. Only 1 company in 12 includes sustainability criteria in calculating performance-based compensation for executives, and only 1 in 7 rewards suppliers for good sustainability performance. Among survey respondents, 37 percent named short-term earnings pressure as a reason for poor sustainability results; about a third named lack of key performance indicators and not enough people being held accountable.



Companies could learn a lesson from sporting-goods maker Nike, which directs more of its business to suppliers that receive high scores on its Sourcing and Manufacturing Sustainability Index. This index, one of Nike's tools for assessing factory performance, gives sustainability factors equal weight with quality, cost, and on-time delivery. Nike requires lower-performing factories to resolve issues in a timely manner or else face penalties such as reduced orders or even a termination of the business relationship. The incentives seem to be working: between 2011 and 2013, Nike saw a 19-percentage-point improvement in the number of suppliers that met its standards.



Ultimately, each company must define its own sustainability philosophy in the context of its specific business and mission. The examples described here illustrate the competitive advantages that sustainability initiatives can offer. That said, even the most exemplary commitment to sustainability doesn't change the fact that the earth's natural resources are limited. A longer-term solution will therefore require new—circular and regenerative—business models that decouple economic growth from resource consumption. ■

¹ For more on the research findings and methodology, see Sheila Bonini and Steven Swartz, "Profits with purpose: How organizing for sustainability can benefit the bottom line," *McKinsey on Sustainability & Resource Productivity*, July 2014, mckinsey.com.

² Sheila Bonini and Stephan Görner, "The business of sustainability: McKinsey Global Survey results," October 2011, mckinsey.com.

³ McKinsey conducted a sustainability-assessment survey with 340 respondents from almost 40 companies, exploring why and how companies are addressing sustainability and to what extent executives believe it can and will affect their companies' bottom line.

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Keiko Morimoto

Smarter schedules, better budgets: How to improve store operations

Through activity-based labor scheduling and budgeting, retailers can cut store labor costs by up to 12 percent while improving both customer service and employee satisfaction.

Daniel Läubli, Gernot Schlögl, and Patrik Silén

In recent years, retailers have taken steps to “lean out” their processes and gain efficiencies—with impressive results. Lean-retailing initiatives have yielded as much as a 15 percent reduction in retailers’ operating costs.¹ But with competition intensifying and with customers expecting ever-higher service levels, many retailers are now looking for new ways to further improve productivity and enhance customer service.

One major area of opportunity is workforce management: specifically, labor scheduling and budgeting. Because of the complexity inherent in creating accurate staffing schedules and budgets for a large number of stores, even sophisticated retailers find substantial room for improvement in this area. Off-the-shelf software and solutions—although useful for important tasks such as monitoring employee

attendance and managing payroll—typically produce generic schedules that don’t take into account store-specific factors and workload fluctuations. The unfortunate results include high labor costs, inconsistent customer service, and dissatisfied employees.

If a retailer could better predict the number and skill set of employees that each of its stores needs every day (or, better, every hour) of the week, then customers would get prompt sales assistance, shelves would be replenished in a timely manner, employees would be neither idle nor overworked, and, in most stores, labor costs would go down.

That’s already happening at a few leading retailers. Chief operating officers have begun looking closely at store activities and taking a

more data-driven approach to labor scheduling and budgeting. In doing so, they have captured between 4 and 12 percent in cost savings while also improving customer service—for example, by shortening checkout queues or by having more staff available on the sales floor to assist customers—and boosting employee satisfaction. This level of impact has been achieved at several different types of retailers, from large supermarket chains in Europe to specialty retailers in emerging markets.

A mismatch between supply and demand

Many retailers use workforce-management software to generate a weekly staffing schedule that is unique to each store, usually based on revenue forecasts—more employees work during hours or days when sales are projected to be the highest. Revenue is a sensible criterion for scheduling, but it's an insufficient one because customers' buying patterns (average basket size, average purchase price per item, and so on) can vary by hour and by day. A European grocer found, for example, that manned service counters, such as deli and bakery counters, account for a much higher share of revenues on weekends than they do during the week. On weekends, therefore, the required labor hours increase at a higher rate than revenues.

Furthermore, most retailers don't have a systematic way to account for store-specific factors that affect how long activities take—such as the distance that an employee must walk to transport a pallet from a delivery truck to the storeroom or how many elevators employees can use for bringing products to the sales floor. The same activity can be much more time consuming at one store than at another, even if the two stores have equal revenues.

Just as staffing schedules rarely align with a store's true labor needs, labor budgets, too, are often mismatched with a store's current

reality. Many retailers decide on labor budgets in an undifferentiated top-down manner: for example, they mandate that each store's labor costs must not exceed 10 percent of sales. Store managers can then negotiate adjustments based on their intuition or experience. This simplistic approach relies too heavily on store managers' judgment; it also unfairly penalizes some stores. For instance, a store in which fresh produce contributes a large fraction of sales will be at a disadvantage, because fresh produce takes more time and care to replenish than packaged goods. We found that such differences among stores can lead to labor-cost differences of up to 30 percent, even if the stores' sales are equal. A seemingly equitable top-down directive thus becomes inequitable in practice; some stores can provide exceptional customer service and a relaxed pace of work for employees, while at other stores, stressed-out workers struggle to meet their service-level targets.

Four prerequisites to an activity-based approach

To revolutionize their labor scheduling and budgeting, innovative retailers aren't simply relying on off-the-shelf workforce-management solutions. Instead they are taking an activity-based approach—one that matches store employees' working hours to a changing workload, so that the right employees are working at the right times, performing the right tasks, and spending the least amount of time required for those tasks. Equally important, such an approach helps retailers develop accurate annual labor budgets for each store. An activity-based approach can be immensely valuable, particularly to retailers that employ 20 or more people per store.

Companies have long used activity-based techniques (such as activity-value analysis)

to improve processes and reduce costs, but rarely have such techniques been applied to labor scheduling and budgeting. In our analysis of labor-scheduling logic, we identified four prerequisites for excellence in using an activity-based approach:

- store-specific *workload calculations*, which are informed estimates of how long it takes to complete certain activities (for example, replenishing one pallet) in a particular store, taking into account predefined service and process standards
- reliable *forecasts of “volume drivers”* (such as revenues per department per hour and product flows) for each store, based on sophisticated regression models as well as store-manager experience
- a *flexible workforce*—with a mix of full-time, part-time, and temporary staff—that can adapt to schedules that may change on a daily and weekly basis
- robust *performance-management processes and systems*, with clear productivity and service-level targets, to ensure that all stores are on board and comply with the plan

All four of these prerequisites can be challenging for retailers. We’ve found, however, that the first prerequisite—generating accurate workload calculations—often proves to be the key improvement lever.

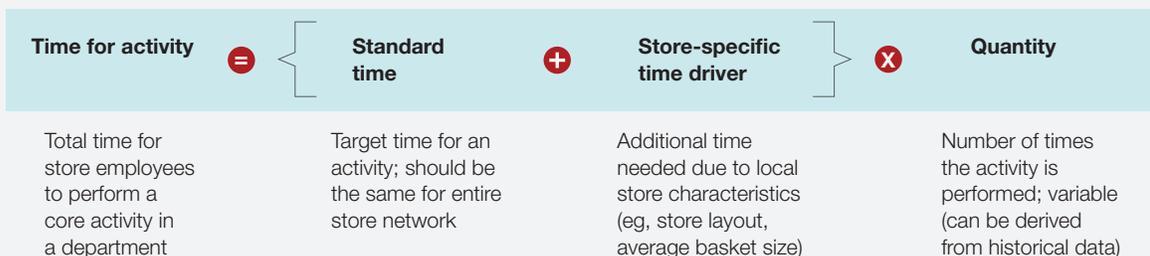
How to calculate workloads accurately

The optimal workload calculations set an expectation for best-practice performance while also acknowledging each store’s unique context. In activity-based scheduling, the time allotted to each activity is a network-wide standard time that is the same for all stores, plus any additional time due to the specifics of each store (exhibit). The network-wide standard time in effect establishes a best-practice benchmark for all stores. Store-specific time drivers can then be measured by observation.

A typical supermarket would use this model to allot time for 50 to 150 activities (see sidebar, “One retailer’s results: Lower labor costs, better store managers”). Some activities will be tricky to model. For instance, figuring out how long it should take to ring up purchases at checkout and how many cashiers should be working at any one time isn’t a straightforward calculation, because customers arrive at

Exhibit

Stores should be allotted the same amount of time for the same task, with some adjustments based on each store’s unique context.



Source: McKinsey analysis

checkouts randomly. For unpredictable customer-facing activities such as these, retailers will need to use queuing theory.²

Retailers should focus on activities that constitute a significant amount of store employees' workload. For instance, developing a detailed model of how long it takes to adjust a shelf to an updated planogram isn't necessary, as this activity typically accounts for less than 1 percent of the total workload. On the other hand, replenishment-related activities can take up to 70 percent of the total work hours in a store.

Implementation and rollout

Implementing an activity-based approach requires a tool that can turn inputs (such as revenue forecasts and customer-footfall estimates) into useful outputs for store managers. Outputs might include the required number of full-time employees per hour and per day, the specific tasks employees should be doing during certain hours of the day, and the associated labor costs.

Retailers typically find it easier and faster to build such a tool from scratch and then inject its outputs into their existing workforce-

One retailer's results: Lower labor costs, better store managers

A large European retailer, with annual revenues in excess of \$20 billion, knew that its stores' scheduling and budgeting processes for labor weren't rigorous enough. At every store, both the standard weekly staffing schedule and the annual labor budget were based primarily on revenues and managerial judgment.

Seeking a more data-driven approach, the retailer decided to pilot activity-based labor scheduling and budgeting in two of its stores over a four-month period. The effort involved calculating the timing of 65 activities and building an Excel-based prototype of a new scheduling-and-budgeting tool for labor. The retailer

subsequently tested the prototype in six additional stores that were quite different from one another, to ensure that the tool's outputs would be relevant to the entire store network. Along the way, the retailer discovered and quickly implemented a number of best practices and process improvements.

The new staffing schedules and labor budgets yielded a 6 percent reduction in labor costs along with an improvement in customer service—gratifying results, particularly in light of the fact that the retailer had recently undertaken a successful lean-retailing transformation and in many ways already had best-practice

store operations. Furthermore, the approach helped expose poor store management. For example, one store was perceived in the company as being well managed because it had notably low labor costs. But bottom-up calculation of the store's annual labor budgets showed that the low labor costs were entirely due to favorable store specifics, such as short distances for transporting products and shelves that were relatively easy to stock. Once labor costs were adjusted for those specifics, the store was shown to be among the least efficient in the network. These and similar insights allowed the retailer to better evaluate and train its store managers.

How quickly the tool is rolled out to the entire store network will depend on available resources, but a store-by-store rollout—whereby an operations coach helps store employees learn about the new tool and any new processes—is often most effective.



management systems, rather than build the tool within their current HR systems. In our experience, it takes approximately six months to develop an Excel-based prototype, pilot it in a handful of stores to test the accuracy of all assumptions and workload calculations, observe its impact on the workforce, and refine it.

How quickly the tool is rolled out to the entire store network will depend on available resources, but a store-by-store rollout—whereby an operations coach helps store employees

learn about the new tool and any new processes—is often most effective. Leadership must ensure that the tool is embedded into daily work and fully linked to HR planning and annual budgeting processes. To keep it constantly up to date and relevant, retailers should consider setting up a scheduling team made up of people who have the requisite analytical skills and who are familiar with store operations. The team would be responsible for maintaining and updating the tool and adjusting the workload calculations to new processes.



An activity-based approach can reveal opportunities for improving store processes. In fact, it can serve as the backbone for a continuous-improvement program; ideally, the new scheduling and budgeting tool would be able to run “what if” analyses for any changes in service levels or process standards. And in the event that labor budget cuts become necessary, management teams—instead of just imposing top-down percentage cuts—will be equipped to lead practical and detailed discussions as to which store activities could be speeded up or eliminated entirely, or where service-level targets could be relaxed. In this way, they will be able to ensure sustained improvements in store productivity, customer service, and employee satisfaction, all while keeping labor costs firmly under control. ■

¹ For more on lean retailing, see Stefan Görgens, Steffen Greubel, and Andreas Moosdorf, “How to mobilize 20,000 people,” *Perspectives on retail and consumer goods*, Winter 2013/14, mckinsey.com.

² Queuing theory is useful for calculating how many employees are needed at a given time to meet the retailer’s target service level. In the checkout example, the target could be based on waiting time (for instance, 90 percent of customers will wait on a checkout line for no more than three minutes) or queue length (for instance, 90 percent of customers will have a maximum of two people in front of them at checkout).

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Keiko Morimoto

Is your company a value creator or a value destroyer?

By looking at performance through the lens of economic profit, retailers can better understand the effectiveness of their business strategies.

Dymfke Kuijpers and Simon Wintels

Among global companies, the rich get richer, while those in the middle tend to get stuck there. These were among the findings from our colleagues' analysis of the economic-profit performance of nearly 3,000 large nonfinancial companies in the 2007–11 period. Using economic profit (EP)—calculated as net operating profit minus the cost of capital—as a measure of value creation and an indicator of market-beating strategy, their research showed that just a handful of companies create most of the value. Companies in the top quintile generated 70 times more EP than all the companies in the middle three quintiles combined. Furthermore, these top companies attracted a disproportionate share of capital. And while it's fairly easy for a company to drop out of the top quintile, breaking

into that top tier from the middle of the pack is no small feat.¹

But what about retailers specifically? Does inequality characterize the retail industry as well? We took a closer look at the 237 publicly owned retail companies included in our colleagues' research and combined that information with more recent data on retailer performance, as well as our own experience working with retail organizations around the world. We discovered that tremendous disparities do exist in retail, and the winners are by no means a homogeneous set. Two outwardly similar companies can have vastly different fates: one can be a value creator, the other a value destroyer. We believe our findings have important implications for how retail

executives and strategists should think about where and how to compete.

Success varies across—and within—retail segments

There are huge differences among retailers when it comes to their ability to create value. Between 2008 and 2012,² top-quintile retailers generated 100 times the EP of retailers in the middle three quintiles. And EP varied widely among retail segments, with apparel companies, food retailers, and pure-play online retailers being the top performers (Exhibit 1).

We estimate that publicly owned apparel companies account for only about one-fifth of global apparel sales, but their success is noteworthy. The 24 apparel companies in our sample together generated \$7.3 billion in EP each year on average. Of that amount, more than half—\$4.8 billion—came from just three retailers (Gap, H&M, and Zara). Vertically integrated apparel players especially have been reliable value creators for several years. In 1997, on average, they generated just \$100 million a year in EP; by 2012, that number had increased more than tenfold, to \$1.1 billion, whereas other apparel retailers did not

Exhibit 1 In retail, the greatest economic profit is made by apparel retailers, while department stores are destroying the most value.

Average profit generated, 2008–12, n = 237 retailers, \$ billion

		Top 3 winners' economic profit	Number of companies
Apparel retail	7.3	4.8	24
Food retail	2.1	2.6	53
Internet retail	1.6	1.7	4
Distributors ¹	1.0	1.2	15
Hypermarkets and supercenters	1.0	5.3	15
Home-furnishing retail	0.8	0.8	3
Home-improvement retail	0.7	1.2	10
Specialty stores	0.3	0.7	17
Computer and electronic retail	0.3	1.0	15
Automotive retail	0.3	0.8	11
General-merchandise stores	0.1	0.7	14
Catalog retail	0	0.0	1
Food distributors	-0.1	0.7	13
Drug retail	-0.3	1.0	11
Department stores	-4.1	1.7	31

¹ Does not include food distributors.

Source: Analysis of data provided by McKinsey Corporate Performance Analysis Tool (a McKinsey Solution)

exceed \$200 million each in EP per year during that period. Not all apparel companies are value creators, however: six of the apparel companies in our sample lost value, although their losses were minor compared with retailers in other segments.

Food retailers represent the second-largest value creators in the retail industry—but here, too, the underlying data tell a more complex story. Among food retailers, including hypermarkets, there were about as many value destroyers as value creators. In general, supermarkets with a traditional business model outperformed other types of food retailers such as discount food stores and convenience-store chains.

The third-richest segment, online retail, has come far in only a few years. From 1998 to 2002, pure-play online retailers destroyed more value than almost every other segment. By the 2008–12 period, they had increased revenues 15 times over, bending margins from negative to positive and becoming one of the industry’s foremost value creators.

As for department stores and drug retailers, neither group created value. Both took an especially hard hit in the health and beauty categories, in part because neither department stores nor drugstores responded effectively to the increased price transparency that the online channel offers consumers. Drugstores also lost business to supermarkets that expanded their nongrocery offerings and undercut drugstores’ prices, while many department stores—saddled with an unclear or outdated value proposition—were challenged by new “category killers” such as cosmetics chain Sephora.

That said, retailers in either segment shouldn’t be resigned to losing value. Some drugstore chains have improved EP by adding pharmacies to their brick-and-mortar outlets, for example. As for department stores, it’s important to note that the top three players in our sample did generate EP—a combined \$1.7 billion per year from 2008 to 2012.

Two of the three are discount department stores.

In our sample of 13 premium department stores, only 1—British retailer Marks and Spencer—created value between 2008 and 2012, most likely as a result of a large-scale, multiyear restructuring effort that began in 2001.

How winners earn a top spot

EP has four components: revenues, margins, asset turns or asset leverage (a measure of the capacity to extract revenue from a given quantity of assets), and the tangible-capital ratio, which is the ratio of physical to total capital, including goodwill.³ In most industries, sizable revenues and high margins are enough to earn a top spot in the EP rankings. In retail, that’s not the case; only companies that outperformed their peers in all four components landed in the top quintile (Exhibit 2).

The need to outperform their peers on margins can be an especially vexing problem for retailers. Although top-quintile retailers generate, on average, 70 percent more revenue and have nearly twice the asset turns as top-quintile players in all other industries, margins in retail are slim (4.6 percent for top retailers, compared with 11.6 percent for top companies across all industries).

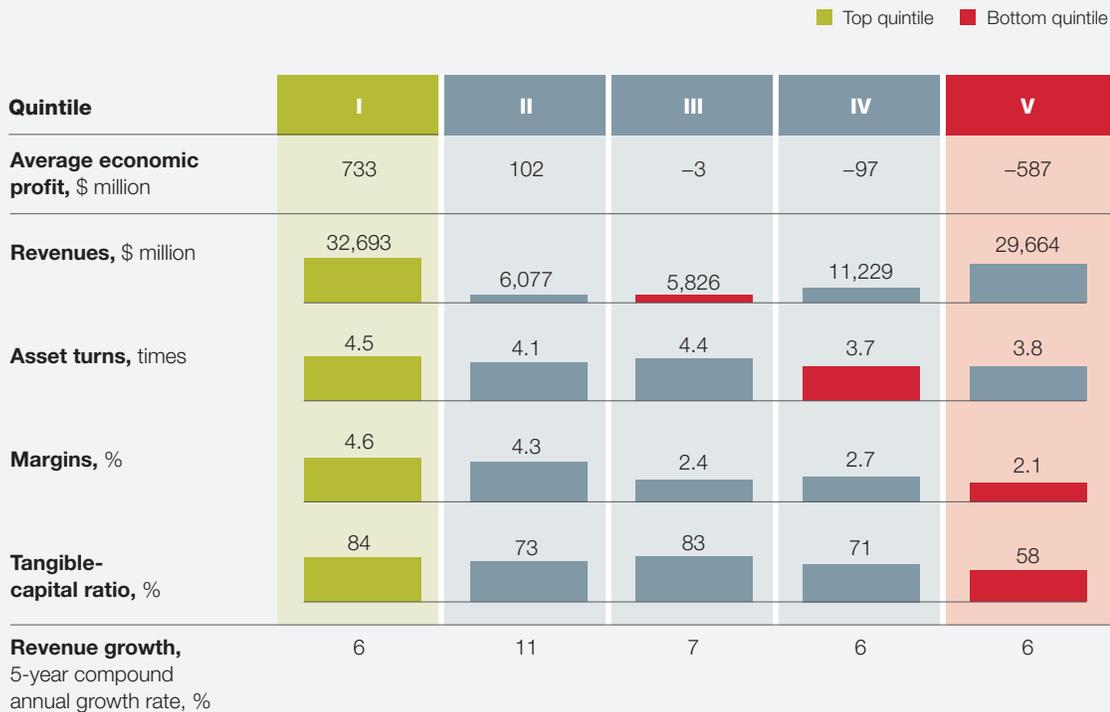
Like their peers in other industries, high-performing retailers shouldn’t get too comfortable. Our research shows that, over a ten-year period, nearly 40 percent of top-quintile retailers dropped into the middle or lower tiers. But losing a top spot doesn’t necessarily take ten years; at least two large retailers dropped from the top to the bottom quintile between 2012 and 2014.

Breaking out of the middle

Even harder than holding on to a top spot is getting there at all. Eighty percent of retailers that were in the middle quintiles in the 1998–2002 period were still in the middle ten years later, meaning they hadn’t significantly improved their ability to create value (Exhibit 3).

Exhibit 2 Only retailers that outperform their peers on all four value drivers can earn a top spot.

Average economic profit generated per year, 2008–12, n = 237 retailers



Source: Analysis of data provided by McKinsey Corporate Performance Analysis Tool (a McKinsey Solution)

Of the 143 retailers that were in the middle quintiles in the 1998–2002 period, only 13 were able to break into the top tier by 2012. Most of them had help from external trends: almost half benefited from emerging-market momentum and four others profited greatly from the massive shift to online retailing. More recent data confirm that mobility remains an issue for middling performers; 85 percent of retailers who were in the middle quartiles in 2012 remained there in 2014.



Our research has several important implications for CEOs and strategists:

Top performers. Maintaining elite status is hard work: even a one percentage-point dip in margins can force a top performer back to the middle of the pack. Retailers that held on to their top spot did so by doubling their revenues while also improving margins, even if only slightly—a 0.6 percentage-point margin improvement sufficed.

Middle of the pack. To earn a top spot, middling performers need to make bold moves and outdo the competition on several fronts: for example, by investing

Exhibit 3 When ranked by economic profit, the majority of retailers are stuck in the middle.

Finish, 2008–12¹

		Top quintile	Middle quintiles	Bottom quintile
Start, 1998–2002²	Top quintile	64%	23%	13%
	Middle quintiles	9%	80%	10%
	Bottom quintile	9%	36%	55%

¹ Based on the largest 3,000 companies by revenues (2011). We excluded companies for which data on normalized operating profit less adjusted taxes and average total invested capital were not available for the full 10-year period.

² Figures may not sum to 100%, because of rounding.

Source: McKinsey analysis

more heavily in revenue-management and pricing capabilities, optimizing marketing and promotional spending, lowering costs through fact-based supplier negotiations, and examining the role of the store network in the organization’s multichannel strategy.⁴

Low performers. For companies at the bottom, revenue growth isn’t enough. Big ideas certainly have the potential to catapult low-performing organizations into the upper tiers, but restructuring might be the first order of business. There’s evidence it can work. Macy’s, a bottom-quartile performer for 15 years, launched a massive restructuring program in 2009; by 2014, it was a top performer. ■

³ Bradley, Dawson, and Smit, “The strategic yardstick you can’t afford to ignore.” There is, mathematically, a fifth dimension of economic value: funding. But the weight of evidence suggests that companies cannot directly influence it. For the purposes of this analysis, we use a global average cost of capital of 9 percent.

⁴ For more on the role of brick-and-mortar stores, see Louise Herring, Tobias Wachinger, and Chris Wigley, “Making stores matter in a multichannel world,” *Perspectives on retail and consumer goods*, December 2014, mckinsey.com.

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¹ For more about the research, see Chris Bradley, Angus Dawson, and Sven Smit, “The strategic yardstick you can’t afford to ignore,” *McKinsey Quarterly*, October 2013, mckinsey.com.

² Our colleagues’ research focused on the period from 2007 to 2011; this article is based on retailer performance from 2008 to 2012.

Growth in the packaged-food industry

The drivers of revenue growth are investment in the right markets, M&A skills, and a pragmatic approach to execution.

Yuval Atsmon, Rogerio Hirose, and Udo Kopka

When it comes to revenue growth, it is often the case that where you play matters more than how well you execute. This broad conclusion about what makes companies grow¹ certainly applies in today's packaged-food industry: the fastest-growing companies are those that have chosen to compete in the fastest-growing product categories and geographic regions.

Using our proprietary analytical approach for decomposing company growth, we analyzed the performance of 20 packaged-food companies in the 2008–12 period, disaggregating their positive and negative revenue growth into three sources:

- portfolio momentum, or the growth attributable to market expansion in the categories and countries in which a company plays
- M&A and divestitures
- execution, measured in terms of market-share gains or losses

Our sample consists of a diverse mix of regional leaders and global players. The granularity of the data allows for deep, nuanced analysis. For example, instead of simply analyzing the broad category of bakery products, we can drill down into subcategories: from biscuits, to sweet biscuits, and then to chocolate-coated biscuits. We also examine companies' performance by country, not just by region. This fine-grained view yields detailed insights as to which factors drive a company's growth and which factors slow it down. (Our reviews of 2013 and 2014 consumer-goods data further confirm our findings.)

Portfolio momentum: Still by far the primary growth driver

Between 2008 and 2012, portfolio momentum accounted for 71 percent of total growth. Companies doing business primarily in emerging markets or in high-growth categories did particularly well: their revenue growth was three times that of more geographically dispersed or more diversified companies.

The fastest-growing companies follow one of two models. The first model, represented in the bottom-left quadrant of the exhibit, calls for a focus on a relatively small set of high-growth subcategory and country combinations (such as sugar-free gum in China or fruited spoonable yogurt in Brazil). Emerging-market companies in expansion mode typically follow this model, and we expect that they will steadily expand into even more subcategories and countries. The second model, as shown in the top-right quadrant, is one that some developed-market players have followed: they are present in a much bigger set of subcategories and countries. But we expect that these large companies, rather than expanding further, will instead abandon the least promising areas and concentrate their resources on the highest-growth subcategories and countries.

These findings prove yet again that applying a granular approach to growth is crucial to gaining competitive advantage. In a business environment where outexecuting the competition offers little reward, a data-driven methodology for identifying the categories and geographies with the highest growth potential is of utmost importance.² Company leaders should also create mechanisms that allow them to

regularly and swiftly move resources—not just capital spending but also personnel, marketing dollars, and other expenditures—away from low-growth areas and toward high-potential markets and segments.³

M&A can partially offset lack of organic growth

M&A accounted for 27 percent of revenue growth in the 2008–12 period. The top two quartiles in our sample wielded M&A as a competitive weapon, with deal activity accounting for almost one-third of their total growth and partially offsetting lower portfolio-momentum growth.

We expect that the M&A landscape will evolve in the next few years, as today’s nascent emerging-market companies grow in both size and aspiration and as

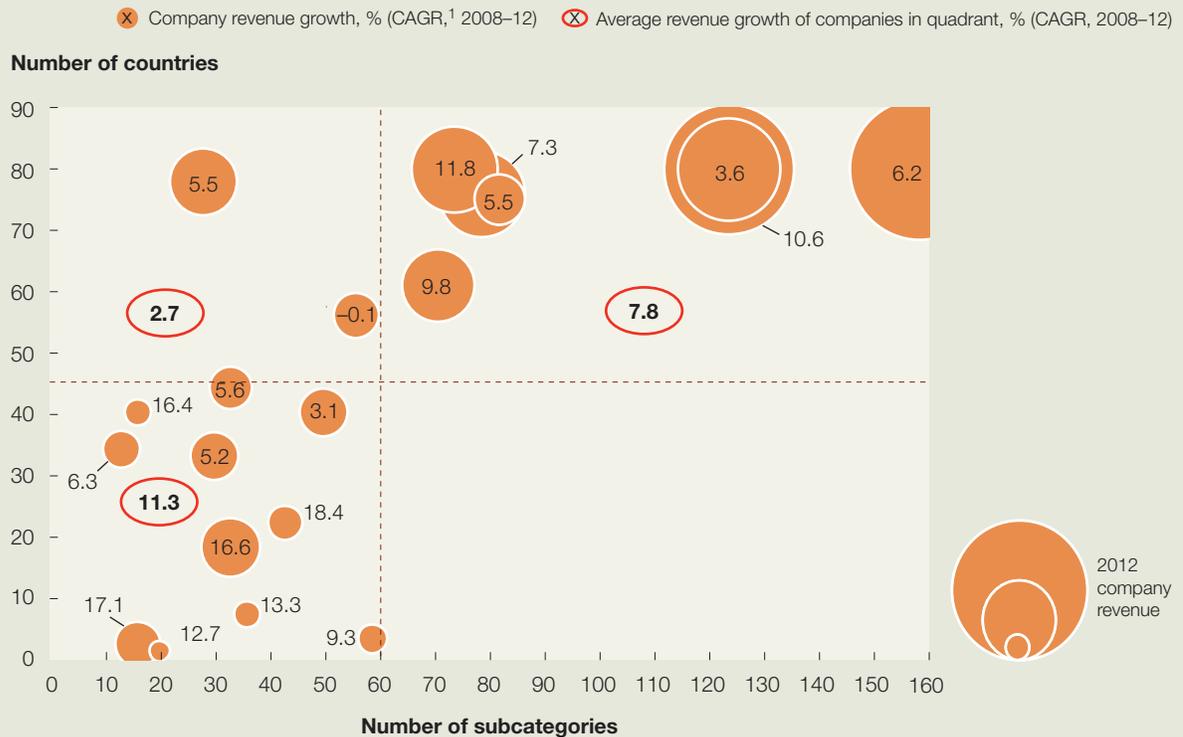
multinationals refine their strategies in response to these new competitors. Packaged-food companies—particularly those with significant exposure in slower-growth countries and categories—should build their deal-making capabilities, so that M&A can become a more reliable and consistently profitable growth driver.⁴

Execution: Table stakes, but rarely a differentiator

As the packaged-food industry becomes increasingly global and more competitive, execution is becoming simultaneously more challenging and less of a differentiator: execution outperformance accounted for a scant 2 percent of total growth in the 2008–12 period. Winning market share away from competitors has only become harder.

Exhibit

Geographic expansion leads to strong growth only for companies that play in many subcategories.



¹Compound annual growth rate.
Source: Euromonitor; McKinsey analysis

Some companies look to new-product introductions as a way to spur growth. But the data show no correlation between execution-related growth and the number of new-product introductions per \$1 billion in net revenue. In other words, large companies that introduced twice as many new products as their similar-size peers didn't fare any better or worse in revenue-growth terms. These findings indicate that innovation is important for maintaining share and keeping developed-market consumers interested in a category, but in general companies haven't built product-development and product-launch capabilities that are differentiated enough to help them capture market-share gains.

Excellence in execution is table stakes, not a trump card. Companies should therefore take a pragmatic approach to execution, prioritizing execution levers in the categories and markets that matter most.



Unquestionably, packaged-food companies that examine their business results up close can make wiser portfolio choices. Companies should scrutinize the performance of each of their geographic markets and subcategories to understand the true sources of growth. Otherwise, they risk investing in the wrong things, missing valuable opportunities, and ultimately losing out to more attentive and analytical rivals. ■

¹ This conclusion was first put forward by Mehrdad Baghai, Sven Smit, and Patrick Viguerie in their seminal book, *The Granularity of Growth: How to Identify the Sources of Growth and Drive Enduring Company Performance* (John Wiley & Sons, 2008).

² Claudia Benschimol Severin, Rogerio Hirose, Udo Kopka, Subho Moulik, Taro Nordheider, and Fábio Stul, "Finding profits and growth in emerging markets," January 2012, mckinseyonmarketingandsales.com.

³ Michael Birshan, Marja Engel, and Olivier Sibony, "Avoiding the quicksand: Ten techniques for more agile corporate resource reallocation," *McKinsey Quarterly*, October 2013, mckinsey.com.

⁴ For more on how to treat M&A as a strategic capability, see Cristina Ferrer, Robert Uhlener, and Andy West, "M&A as competitive advantage," *McKinsey on Finance*, August 2013, mckinsey.com.

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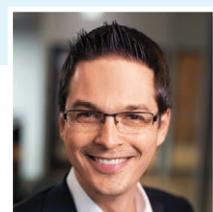
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