OLIVER WYMAN

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# RETAIL & CONSUMER JOURNAL

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# Foreword

Continuing upheaval in retail and consumer makes for very exciting and – at least for some – distressing times. Online commerce is advancing like a tsunami, and engulfing an ever-wider range of segments, including some that in the past were critically dependent upon physical stores. Big changes are afoot.

New models are encroaching ever more on traditional ground. In sectors which in the past seemed critically dependent upon physical stores, online is gaining traction. Manufacturers have started to sell their products directly to consumers. And high-profile moves are underway to crack food – the biggest retail segment, and so far the most-resistant to the internet challenge.

This year's Retail and Consumer Journal takes a sweeping view of a world buffeted by change that is taking place at unprecedented pace. We examine the emerging opportunities – and threats – and highlight the clever and innovative ways in which companies are responding. We conclude that, for all kinds of retail – online, brick-and-mortar, and omnichannel – the end game lies a considerable time out in the future, and there is still all to play for.

Despite its seemingly inexorable growth, online commerce nonetheless still faces an array of barriers. Logistics, economics, and the "last mile" all come to mind – but for many the biggest hinder may well be consumer psychology. Shoppers love going online to sift through a large range of items – but they often find the experience falls short. When it comes to apparel or cosmetics, for example, the perceived cost of disappointment is high. Customers want to try before they buy. And they also want to smell and touch produce before taking it home.

Can online really compete here? It seems the answer is yes – or at least a qualified yes.

In non-food, augmented reality techniques are helping to overcome "look and feel" barriers. And no-cost, easy return policies seem to be reassuring shoppers they will not be stuck with clothes that do not fit or cosmetics which do not live up to expectations. In food, the bar is higher. The cost and quality of delivery have been major impediments to consumer uptake. Amazon's purchase of Whole Foods Market may well lead to solutions for online food shopping. Watch this space.

One way to thrive – whether or not a particular retail segment moves online – is to produce outstanding products and ensure they are available anytime, anywhere. Fashion giants have done this by getting new styles to stores, and reacting to customer trends faster than the competition – it is called "fast fashion". However, for many labels, a complete focus on "fast fashion" is too costly to be practical. Instead, these apparel makers are innovating themselves, borrowing many of the techniques of "fast fashion", but adapting them cleverly as well. A new paradigm is emerging – we call it "smart fashion".

Another way to meet threat and address opportunity is to do what one does best. In food, for incumbent supermarkets, that means focusing on Fresh. Experience and reputation in this area provide grocers with real advantages, and a potentially winning hand against online encroachment. Nonetheless, success here requires skill, investment and a steely focus on execution. We review how the best are playing their hands.

For other sectors, the answer may well be more about being a fast follower. Large beauty brands seeking to stand out more should take a look at what some newer, smaller rivals are doing. Instead of selling their products in the traditional way – through department stores – they are setting up their own boutiques in order to define their products sharply and provide a compelling experience. We take a closer look at what big companies can learn from nimble first movers.

Traditional recipes for success still have an important role. One such model is to look for new sources of revenue by moving into adjacent areas. Food manufacturers, for example, are anxious to avoid being confined by a flat market and so are developing health-related products and functional foods. Health is emerging as a mega-trend - we see a huge market in the making.

Others are taking successful models and transferring them to new geographies. German discounter Lidl entered the US market in 2017. It is early days, but first indications are that the US grocery market is in for a shock. A repeat of the very sobering UK experience of German hard discounting is not out of the question – not at all.

Some of the most intriguing new business models are being developed in China – which has seen explosive online growth in recent years. Though the country's vast market and dense urban populations make it exceptional, in some areas Chinese retailers may be pointing the way towards the future of retail. But online selling is not just for retailers, and not just for the Chinese. We take a look at lessons learned, and how they can be applied elsewhere.

Still others are taking a hard look at sacred cows, and fundamentally questioning whether the structures of the past are fit for purpose in future. For many, the answer will be no. In the digital age, cost leadership is crucially important. To achieve leadership means radical change. New technologies are making such transformation attainable, allowing step changes in cost performance and providing a viable platform for continued survival and success.

We hope you enjoy this year's edition of the Retail and Consumer Journal, and look forward to hearing your feedback.

James Bacos

**James Bacos**
Global Retail Practice Leader
james.bacos@oliverwyman.com
+49 89 939 49 441

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# THE FUTURE OF RETAIL IS OMNICHANNEL

## MOST CONSUMERS LOVE THE IDEA OF SHOPPING ONLINE, BUT SHARE REMAINS LOW. WHY?

People hate shopping online because the web interface can be slow and clunky, providing poor photos and confusing information. Delivery costs are high and waiting at home for a delivery is inconvenient. Worst of all, there is rarely anyone to speak to for help.

People love shopping online because they can consult a limitless catalogue, filter rapidly by feature and price, and consult user and expert reviews. They can also compare retailers for the best prices. Best of all, they can skip physical stores' check out queues and the traffic jams en route.

An omnichannel model that gives consumers the best aspects of traditional shopping – and spares them the worst – will be a key to the future of retail. Online shopping has already taken over sectors such as music. Yet in other sectors, such as in food, it has been slow to spread.

Our 2017 Digital Shopping survey shows that over 70% of consumers are open to shopping online: they either already shop online regularly, or would switch if the experience or value for money improved. While there is a slightly higher prevalence amongst under-45s, even our 60+ age group was 50–60% open to online shopping for at least some products. Despite this, online sales still only account for 15 percent of the non-food market in much of North America and Europe, and just 3 percent in food.

Two factors in particular have been blocking greater penetration by retailers' online businesses to date, thus holding up the growth of online or omnichannel retail overall: the digital shopping experience and the costs of fulfilment and last-mile delivery. However, we think developments in both areas will lead to big advances.

## MAKE IT FUN, MAKE IT EASY

The online shopping experience has come a long way in the past 15 years. Still, for many shoppers online browsing is not as intuitive as walking through a store – particularly when assembling complex baskets as customers do for groceries. For customers who are less comfortable with the web or mobile browsers, voice-recognition technology such as Amazon's Alexa or Google Home could help make digital shopping a daily activity. Further innovations – for instance through augmented and virtual reality – could make the online experience more compelling, and add some of the theatre put on by physical stores. For example, VR applications that let consumers experiment with different looks help sell make-up online.

In some respects, the digital experience has the potential even to surpass physical stores. Some sectors might develop personalized curation services, such as those offered by Cladwell and Thread. These provide customers the advice they would get from the best stores – perhaps better, as they work with algorithms that know far more about the customer than even the best shop assistants. This kind of digital technology will advance the more it is used, because it improves after training on larger, more-diverse data sets. It could be licensed to multiple retailers, saving them the development costs.

Efficient fulfilment and last mile operations are essential for all retailers, as the costs of picking and delivering online orders are substantial. In food, for example, delivery fees can run to over 10 percent of the average basket, discouraging new customers. Today, retailers typically either pass some of these costs on to the customer through high fees or a large minimum order, or they take a profit hit from absorbing these – which means they tend to offer fewer delivery slots to save costs. So reducing the cost of last-mile delivery will be the key to improving this aspect of the consumer experience and increasing adoption.

By understanding these drivers, we can model the effects of rising consumer demand, fees and other barriers, and the supply-side cost structures of different countries. We can then predict the likely online share in each sector under different scenarios. The UK is one of the world's most advanced grocery markets, but costly packaging and delivery still necessitate

**Exhibit 1: We believe "blocker removal" has driven and will continue to drive customer adoption**
Current blockers of online food, about to be addressed

| COST | PRODUCT TIMING | CHOICE |
|---|---|---|

**Infrequent drop times**
Retailer-logistics partnerships to unlock "spare capacity" of vans already passing
For example: Amazon/DHL

Dynamic routing specialists to further optimize delivery routes and mix food and non-food
For example: Cogepart

**High delivery for cold chain**
Passive cooling technologies – transport Fresh in any lorry
For example: DPD

Smart labels that flag when food has warmed – eliminating the safety risk
For example: Timestrip

**Unpacking goods**
Refrigerated locker technologies
For example: Freskissimo

In-fridge delivery service
For example: August Home

**Unwieldy product selection**
"Buy this recipe" plug-ins
For example: Whisk

Recipe boxes
For example: Linas Matkasse

Source: Oliver Wyman analysis

fees or minimum basket sizes. Our prediction shows that if current fee levels persist in the UK, then the online share of food retail will probably peak at 8 percent, not far above the current level of 6 percent. However, if costs decline and fees disappear, online share could rise to 16 percent by 2030, and continue on up. It will be easier to reduce delivery costs in densely populated areas, where a large number of deliveries can be made in a given journey time. But if cost-effective delivery also becomes feasible in sparsely populated areas, the online share of food might be as high as 19 percent by 2030.

# PARTNERSHIPS SAVE TIME AND MONEY

To date, many retailers have struggled to deliver these improvements in online shopping. Some of the new capabilities are costly to develop, and many physical retailers lack the right skills. They also have less innovation in their DNA; they face a higher cost of capital than online incumbents and well-funded startups; and they fear that their efforts could result in self-cannibalization.

One solution – which is becoming more prominent – is to obtain the necessary capabilities from elsewhere. Traditionally, a store has sent round its own truck for home deliveries, but from now someone else might fulfil the task, as DHL does for Amazon Fresh in Germany. A greater variety of services will likely crop up: Passive-cooling packaging is widening the range of options, as non-refrigerated vehicles can be used. That might allow Uber-Eats-type arrangements to emerge, with retailers taking advantage of networks of freelancers. In future, delivery might be supplied as a utility. To enhance the shopping experience, rather than trying to develop voice recognition algorithms in-house, Walmart has partnered with Google Home to use its mature software to deliver a seamless voice-ordering experience.

Forming this kind of partnership is far from straightforward, but retailers of all sizes are increasingly adopting the tactic. Smaller supermarkets such as Morrisons are turning to Ocado, an online supermarket with no stores of its own. Primark, GNC, and Trader Joe's are partnering with e-commerce platform specialists such as Aptos.

So, the consumer of the future will increasingly make purchases online. Penetration will increase with changes in attitude and technical literacy, but mainly because of barrier removal: innovations that make e-commerce more efficient and more fun. The winners in the new era will be those who beat the peloton to offer these sooner, without wasting millions on doomed attempts to develop capabilities in-house. Once the right technical or business process solutions have been found, they can be adopted rapidly across the industry thanks to the rise of specialists and strategic partnerships – which will be major accelerators of online penetration.

Consumers may soon find they have many more reasons to love online shopping than before – and shift their habits accordingly.

# AMAZON PLOTS THE FUTURE OF FOOD

## THE PURCHASE OF WHOLE FOODS IS A STEP TOWARDS A MAJOR PRESENCE IN FOOD RETAIL

Amazon, the biggest online retailer, has so far taken only tentative steps into groceries, the biggest retail market. It has launched AmazonFresh and its Amazon Go no-cashier stores, but it has been held back by the seeming incompatibility of the food business and Amazon's traditional business model: People often buy small quantities of fresh products frequently, and they like to be able to see – and feel – the fresh products they are buying.

The acquisition of Whole Foods Market in June 2017 will take Amazon's food presence to another level. Amazon has lacked a great range of food products; Whole Foods is a recognized, trusted brand with a fantastic assortment. Amazon did not have expertise in running a groceries business; the acquisition brings with it an understanding of on-the-ground food retailing. And by combining sales of food and other items, Amazon will gain scale that reduces the cost of delivery and enables price reductions across the grocery range.

By acquiring these elements and applying its digital technology, Amazon is thus heralding a new era in the food sector, which was why the deal was the biggest news item of the year in the sector. Supermarket stocks fell in expectation that Amazon will take market share off incumbents and could trigger price deflation throughout the market. We expect to see further consolidation as weak players go out of business or are acquired – perhaps first in the United States, but soon spreading to other countries. Further ahead, Amazon could change the way people shop for groceries, turning a business that delivers a good-food – into one that provides a service by fulfilling food needs through an array of customized suggestions and subscription services.

## FIRST MOVES

In the short term, Amazon will look to derive value from the acquisition and start experimenting with future ideas. Whole Foods has already started to lower its prices in order to lose its "whole paycheck" reputation for being expensive. This could attract a greater range of customers: Time and again, Amazon has been willing to invest heavily to dominate its chosen categories. Amazon will also aim to sell its staples – such as shampoo, detergent, and dry groceries – to Whole Foods customers: By dedicating itself to premium, predominantly

fresh food, Whole Foods has left a significant headroom opportunity, the unmet spending potential of their affluent shoppers. These additional sales will help pay for the price cuts on Whole Foods' core fresh assortment.

In addition, Whole Foods stores will function as click-and-collect points for buyers of Amazon's other products. That will reduce costs and delivery times and attract potential customers who find home delivery inconvenient today. This extra customer traffic will lift the stores' food sales too. More generally, Whole Foods will bring the valuable capabilities of a decentralized, local organization. Its local customer knowledge and connection to local suppliers are among the best in the industry. Combining them with Amazon's efficient, centralized, technology-driven approach could be a tremendously powerful combination in both Amazon's and Whole Foods' traditional markets.

Amazon will likely ramp up its fresh food operations step by step, adding and testing new features and ways of combining online capabilities and physical stores. An early example was its move to make Amazon Prime the loyalty program for Whole Foods. Piece by piece, Amazon will remove the barriers to online fresh food sales, notching up economic advantages that will enable it to offer unbeatable prices for food just as it does for other products. Many of the necessary elements would be difficult or take time to build. But Amazon has in one go acquired top-quality own-label products, a nationwide network of stores, and a temperature-controlled supply chain – not to mention Whole Foods' large set of affluent customers.

Not all of Amazon's moves will seem obviously related. It will be like a magic picture that first appears to consist of formless dots, until you stare at it for a while and the image becomes clear. That picture will be the future of food retail, which has for the most part remained stubbornly offline for a number of reasons. Delivery is expensive. People worry that the fresh food will not be what they want or might arrive in poor condition. Moreover, they do not see that much to gain by shifting from supermarkets to online food shops. Amazon will gradually provide fixes for these problems.

# QUICKER, CHEAPER, MORE FREQUENT

The first steps to unlock online food are likely to be improvements in delivery. This has been very hard for fresh food, which requires special conditions: Each foodstuff must be kept at the right temperature, and it must arrive quickly, as customers often buy fresh food for cooking the same day. People do not like waiting around for deliveries, so slots must be narrow, which can mean a van having to make multiple trips to a single area. As a result, delivery is expensive, leading to measures such as charges or minimum order sizes that run counter to many consumers' desire for small quantities to eat right away.

Amazon is already chipping away at the problem. Many AmazonFresh customers add one or two high-margin non-food items to their baskets, making food dispatches more cost-effective. This may not sound like much, but it can transform a loss-making order into one that breaks even or even turns a profit, giving Amazon a huge advantage over retailers without this capability.

In Germany, Amazon has formed a partnership with DHL, which has a highly efficient delivery network. Passive-cooling technology makes frequent deliveries viable, as they can be carried out in regular – instead of refrigerated – trucks. That means food can be sent in the same trucks as other items, making small, frequent baskets more cost-effective. This approach could enable rapid, on-demand delivery services, which already exist in many urban areas, to deliver food as well  as regular parcels.

Other creative options can be expected too. Amazon could proactively suggest orders at times when a van is scheduled to be in the neighborhood, and optimize slots in real time to coordinate different customer requests: "Would you mind if the order came 30 minutes earlier?" Uber-type networks for delivery might emerge. All these possibilities will make fulfillment more efficient, reducing Amazon's costs and the prices it needs to charge.

# AMAZON AS FOOD BUTLER

The step change in online food will come from sophisticated, artificial intelligence-driven services that help customers plan and manage their food needs. Shoppers will select products the way they find easiest, using auto-populated lists, setting parameters for an app to make suggestions, or simply barking an order at Alexa, Amazon's voice-interactive personal assistant. Subscription services could monitor store cupboards and then suggest additional items to complete a new recipe. As Amazon gets to know individual customers' preferences, dietary requirements, and seasonal habits, it will take over the management of household items and act as a digital food butler.

Food retail will thus be transformed into an information business, driven by the collection, analysis, and use of data. Not only will Amazon benefit from its digital lead in overall retail, it will also get a first-mover advantage in machine learning for food sales. Algorithms improve as they absorb more data, and Amazon will gather more information than other retailers because it will be ahead of the game in more markets. The data will be incredibly valuable, as it will probably be the best (and perhaps only) global treasure trove of information on food purchasing habits. Food manufacturers – that is, Amazon's suppliers – will be prepared to pay a lot for this information and related analysis, improving Amazon's economic model further. Amazon could soon have an unassailable competitive advantage.

# WHY RETAILERS NEED TO FOCUS ON COST STEP CHANGE

Many retail banks have slashed costs dramatically over the past decade by promoting digital services, closing physical branches, and taking a hard look at the activities done in head office. Mobile telecoms operators in Europe have cut more than a third of their costs per subscriber, by reducing non-essential activities and improving the efficiency of the remaining tasks. In both cases, the motivation was to remain profitable even as individual customers brought in less revenue, and market growth was low.

Retailers are facing the same problem, and it is time now for them to do the same. Though retailers have always been cost conscious, they have traditionally focused on incremental reductions to shave low-single-digit percentages off overall cost levels. Now, however, they need to take big, radical steps that will slash costs by between 20 and 40 percent.

*This article first appeared in* HBR China.

## Exhibit 1: Other industries have faced similar challenges already: Telcos responded to revenue decline by cutting costs by 20 to 30 percent or more in 8 years
European telco cost reductions in opex per subscriber, in percent

PERCENT



1. Demand management
2. Reduction of unnecessary activities

3. Efficiency improvement of remaining activities
4. Reduction of factor costs
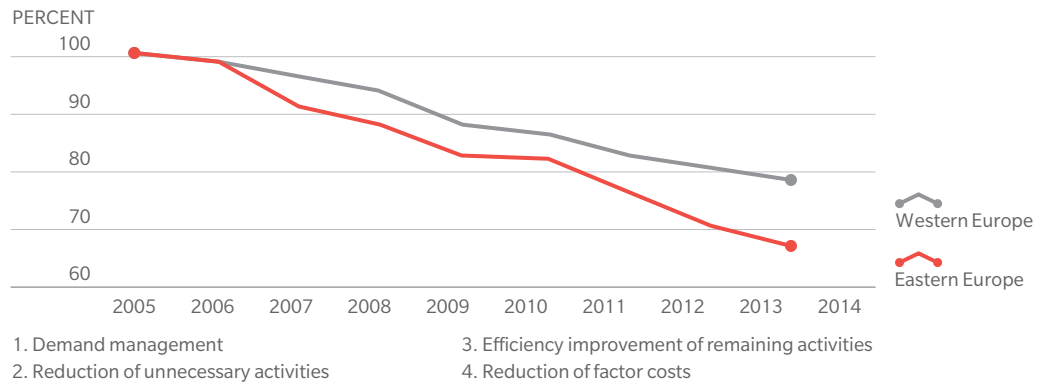
Source: UBS, Wireless Matrix (BoA, Merrill Lynch), Informa Telecoms & Media, CISCO, IEEE, Oliver Wyman research. Only IP traffic included in Fixed BB

The mentality needed is a "green-field" or "zero-based" approach. Instead of tweaking and optimizing existing structures and ways of working – anchored by the idea that "this is how we have always done it" – they need to rethink their businesses from scratch. That means keeping only what they absolutely need to do – tasks that are truly critical or have a real business case – and eliminating "nice to have" activities and elements of the proposition. For example, the HR department may consider building an employee brand as critical, but the rest of the business only views it as "nice to have." Bread baked from scratch may have always been part of the store proposition, but customers may not notice the difference to a more efficient bake-off alternative.

## Exhibit 2: The banking industry has cut costs due to regulatory pressure and digitization, with more to come over the next few years
Wholesale banking cost reductions 2010–2020 target, in percent
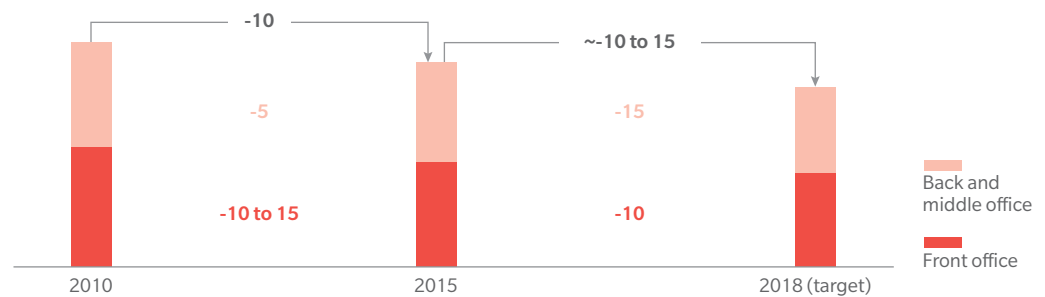


Note: The range on front office spending is broader than for back and middle office functions, driven by a greater ability to flex compensation; it is also performance dependent

Source: Company filings and annual reports; Oliver Wyman proprietary data and analysis

The difficulties retailers are facing range from flat or slowing consumer demand, increasing labor costs, and excess space, combined with the rapid rise of new disruptive challengers in the shape of e-commerce and discount players. Variations of these problems have struck other industries, for example: deflating profits from low interest rates combined with new FinTech disruptors in retail banking; squeezed revenues via regulation combined with voice over IP in telecoms; and digitization combined with a sustained drop in print advertisement levels in the traditional media business. These industries have been transformed over the past decade, with incumbent firms that have not changed either shrinking or being taken over, and only those who act fast and change fast surviving.

# TO SUCCEED, RETAILERS CAN DEPLOY THREE TYPES OF TOOLS

## DIGITIZATION AND AUTOMATION

Newcomers, including the new breed of digital retailer, provide incumbents with some valuable lessons in how to change. There are now online-only retailers turning over in excess of $1 billion that operate with as few as 200 full-time equivalent staff in the head office. While being mindful of the competition they pose, incumbents can learn from their approach, which at its heart involves automating decisions – such as in category management – with smart analytics, leaving far fewer, more highly skilled people setting the parameters for and adding human insight to the machines. In one study, we found that Amazon managed its business with a ratio of 10x products per person within category management by using this approach.

There are also lessons from other industries. One traditional personal insurance company in Europe revived itself through digitization and automation. It was losing customers to new digital rivals, one of which was able to update its prices every 15 minutes. Another needed only 30 customer service staff on 750,000 policies – radically leaner than the incumbent's model.

These disruptive benchmarks helped the insurer realize the need for radical change. They started by introducing new low-cost digital services, such as letting customers log and track their claims online. It also created a digital one-stop shop for its claims suppliers. Finally, a custom analytics engine looked at 8,000 risk factor combinations, 750,000 data points, and over 200 million individual quotes, and delivered weekly risk assessments of its clients. Changes such as this enabled significant head office cuts, with the insurer reducing annual costs by over €100 million in 18 months while boosting profit margins by over five points. The company also began to react more agilely to competitors' price changes.

## SIMPLIFICATION

Another powerful tool is simplification. In some product categories, retail customers do not value a broad choice – for example, in basic areas such as household goods or commodity cooking ingredients. Removing some of the "tail" can simplify the business and reduce costs. This needs to be done carefully, by focusing on duplicative products and avoiding low-selling products that do actually fulfill a unique customer need. Simplifying the range in this way enables efficiencies in supply chain and store operating models: It reduces the number of picking slots, simplifies depot operations, and makes in-store replenishment faster, easier, and cheaper. Narrow ranges can still serve customer needs incredibly well if they are well designed. For example, in Spain, low-cost retailer Mercadona delivers a hugely successful supermarket model with about 9,000 carefully selected products rather than the 30,000 (approximately) of a traditional supermarket.

Thinking about cost in an integrated way can reduce overall costs. For example, faster checkouts were achieved by placing bar codes on fresh products to ensure that they scanned first time. The checkout counter was raised so that items are slide directly through the bar code scanner and into the shopping cart. This all improved "time per customer," reducing cashier costs. The retailer reduced the number of products in a typical store by a quarter, helping to cut supply chain costs by 20 percent, store labor costs by over 30 percent, and other store costs – such as utilities, maintenance, and cleaning – by over 5 percent.

## CHALLENGING SUPPLIER RELATIONSHIPS

Retailers can simplify their operations by reducing the number of suppliers they work with (often linked to the range simplification mentioned above), and generate more value from these relationships by collaborating more closely with a smaller number of suppliers. Supply chain processes are often based on historical ways of working, making them ripe for optimization, particularly in fresh categories where small amounts of lost time radically affect shelf life.

Retailers and suppliers can, for example, rationalize delivery, by using less-busy windows or alternative routes, pooling delivery services with others, using third-party logistics providers, and centralizing certain steps such as packing and picking. A crucial aspect of successful relationships with suppliers is information and data sharing. There must be a clear mutual understanding of which pieces of information are critical at each stage of the supply chain. This can make it easy to speed up the most important steps. In some situations, an approach of working closer with a smaller number of key vendors can release cost savings of up to 10 percent.

# A RADICAL ZERO-BASED APPROACH

Simplifications to the proposition and supplier relationships also need to be used to enable simplification and reduction in the size of overhead departments. And this is where a "zero-based approach" can be powerful.

The first step in a zero-based approach is to identify a "survival minimum" for each department or administrative area. They will need to continue essential administrative tasks, such as regulatory reporting, and to maintain standards for health and safety. But beyond this, the survival minimum should eliminate frills and comfort.

Second, they need to identify the "strategic minimum." This adds some key strategic priorities onto the survival minimum – only activities that are supported by a strong business case, for example, because they support a key aspect of the customer proposition. In the HR department, for instance, the survival minimum may only include staff who are crucial for legal requirements, whereas the strategic minimum would include a key training function responsible for customer service in the stores.

Then, the "optimization target" becomes the difference between today's level of cost and the strategic minimum. Retailers should watch carefully how other industries have dramatically improved their cost position and look at what online retailers are doing. However, they will only be able to emulate some of their success if they think big. If they redesign their products and services for a low-cost model, retailers can follow those other industries into a profitable future. It will not happen overnight, but the possibility is there for retailers who want to take it – and want to survive.

## Exhibit 3: Amazon can make better decisions more quickly and with fewer people

FEWER DECISION MAKERS...

SKUs per merchant
*Office supplies only*

~10x

Traditional retailer        Amazon.com

...RESPONDING MORE RAPIDLY...

Price changes per day

~50x

Traditional retailer        Amazon.com

...MAKING BETTER DECISIONS

Case study: The power of data

*"The Amazon team was able to use [pricing] data in discussions with their supplier, who in turn realized that their own pricing errors had given Amazon's competitor a price too low"*

Note: Estimated using products listed on Office Depot and Amazon websites, excluding third-party resellers; Based on analysis from Profitero

Source: Amazon.com, Officedepot.com, ZDnet.com/Profitero, Oliver Wyman analysis

# THE FUTURE SUPERMARKET

## HOW DIGITAL OPERATIONS WILL ENABLE A WINNING CUSTOMER EXPERIENCE, AT MUCH LOWER COST

The Amazon Go concept store raises a question about the future of supermarkets: How many people will stores still need to operate? The Amazon Go store works by allowing registered shoppers to remove items from shelves and leave without going through the checkout; the required payment is automatically deducted from the customer's card. Checkout is not the only store operation that can be automated, and future supermarkets with a high degree of digitization could operate with around 40 percent fewer labor hours.

Reductions in retailers' wage bills will make it easier to keep stores open round the clock. Nonetheless, we think people are likely to remain an essential feature of stores, as well-trained, knowledgeable service staff are the best way for grocers to directly connect with their customers, and deliver a memorable experience. As shopping migrates online, brick-and-mortar stores will need to respond by turning shopping from a transaction into a pleasurable lifestyle activity. They can do this by providing special features to improve the overall customer experience. Such upgrades could include superior fresh-food offerings, food courts, gastronomic areas, and cookery classes to enable customers to learn new skills. Each of these elements will need to be combined with expert advice – and will be labor-intensive, as well as expensive to provide. To fund these expensive investments, stores will need to deploy modern automation technologies to free up staff from routine operations so that they can focus on the more-interesting activities that add the greatest value for the customer.

While the most visible changes to supermarkets will be these new customer-facing features, digital tools will transform supermarket operations in less obvious ways. Before customers arrive in store, they can assemble their shopping lists through online apps – informed by merchandising, social media, personalized promotions and recommendations driven by

artificial intelligence. Customers will flip through recipes on a tablet or smartphone as they sample products in-store, and can even make online orders for home delivery or to pick up as they leave the store.

On display shelves, some stores have already introduced electronic price tags that are updated automatically, saving the bother of swapping paper tags. These electronic tags can also facilitate dynamic pricing, for example to discount products that are overstocked or about to reach expiry date. In the future, customers' smartphones may display personalized prices, replacing uniform prices for all shoppers. This tailor-made approach would allow supermarkets to deliver highly personalized offers that take into account a customer's profile, shopping history as well as current location within the store. The result will be a highly individual interaction with customers both in stores and online.

Floor space for the new features can be freed up by shrinking the space currently allocated to canned and packaged products. Detergent, washing-up liquid, and paper towels form part of "chore" shopping and provide little to attract consumers to a store. Supermarkets could create a virtual version of the center store, where customers scan items on a barcode wall to add to their virtual baskets, and then pick the items up later or have them delivered to their homes. The products will mostly remain in the backroom storage areas, simplifying the picking process.

To smooth the flow of goods through their stock rooms, stores will need more effective picking systems. Depending on lead times and customers' use of digital shopping lists, some orders can be picked in centralized warehouses separated from the stores. These items can then be combined with the products that shoppers add in the supermarket, providing a genuinely seamless shopping experience across every channel. Stores' forecasting and ordering decisions will be fully automated using machine-learning algorithms and real-time out-of-stock alerts. Smart tools and algorithms will help to plan just the right level of convenience food production. At the food court, employees will use standardized meal kits to maintain high levels of product consistency and operational efficiency.

Automation is already changing checkouts and, in the future, customers will expect no lines, no transaction time, and one-click cashless payments. The Amazon Go system uses a combination of digital technologies to figure out what items each customer is taking from the store's shelves, but these technologies will be too expensive for most supermarkets, at least for now. However, scan-and-go systems that remove the checkout experience are gaining popularity among shoppers. Self-checkout terminals are already a reality at many retailers, and require just a single member of staff to oversee a number of terminals.

A number of these upgrades to the stores will be costly, but technology presents huge opportunities to save money by simplifying basic tasks, as well as providing a better customer experience. We think retailers could already free up 20 percent of their labor just using existing technology and, by systematically optimizing and simplifying day-to-day core processes in the store. By building a superior environment for their customers, enabled through highly-efficient digital operations, supermarkets will be well-placed to compete against their low cost and online competition.

## WAREHOUSE AND BACKROOM

The backroom will house the center store assortment and serve as a picking area. Some online orders will be picked here for home delivery or in-store pickup. Shop-floor replenishment teams can be relocated here.

*Potential increase of labor hours: 100+%*

## FRESH COUNTERS AND IN-STORE SERVICES

An addition to today's meat counter and fresh bakery, this area will be very important. A food court will offer expert advice, a place to socialize with barista-served coffee, and tastings of meals for home delivery or pickup.

*Potential increase of labor hours: 40+%*

TRY THE RECIPE OF THE WEEK

Fresh Meat & Fish

Fresh Bakery Cakes

Local Fresh Produce

Pickup Area

Pickup Area

Pickup Area

Customer Assistance

Collection Point Car park

HEALTHY NUTRITION

Training

Admin

## CHECKOUT

No lines, one-click payment: The future store will offer a much better checkout experience than today. Most customers will use scan-and-go systems, others self-checkout terminals.

*Potential reduction of labor hours: 60+%*

## THE CUSTOMER OF THE FUTURE

The future customer will want to shop anywhere, anytime. A trip to a store will need good reasons. These could include services such as recipe tastings and lunch in the store, or a highly personalized offer and price. Shopping will need to be fun, hassle-free, and experience through multiple channels.
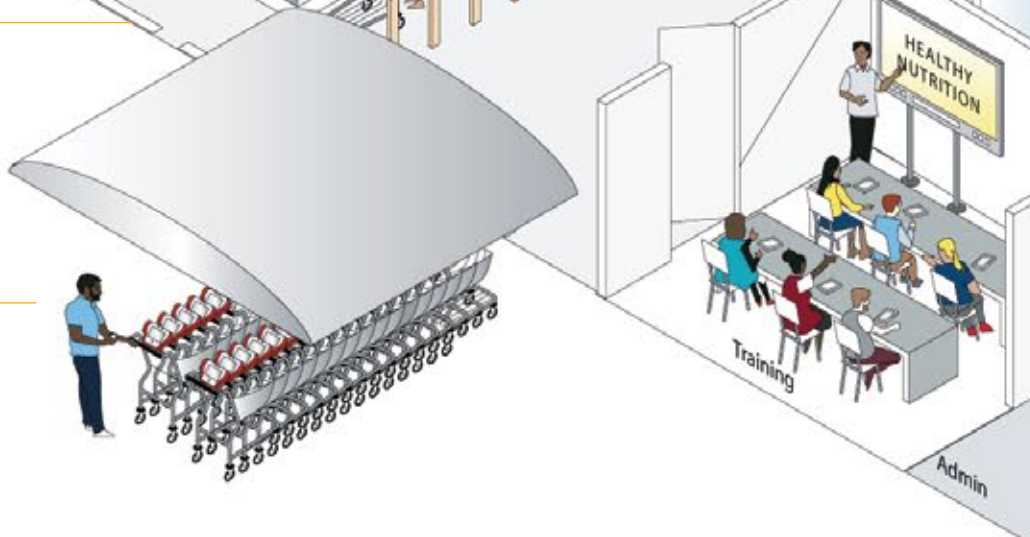
**ORDERING AND REPLENISHMENT**

Forecasting errors will be reduced by machine learning algorithms, making stock management much easier. Center store products will be bought online or from virtual shelves. The stocking of perishables will be a higher priority.

*Potential reduction of labor hours: 50+%*

**SHELF MAINTENANCE**

Electronic shelf labels will enable automatic price updates, reduce effort – especially for discounted products. Personalized prices seen on a smartphone may even replace unified shelf prices. But tasks such as fresh and quality controls will stay relevant.

*Potential reduction of labor hours: 50+%*

**THE WORKFORCE OF THE FUTURE**

Taking advantage of new tools and technology needs staff with a new skill set. Managers need to leave their offices and engage with customers, as good restaurant owners do. Staff at new areas like the food court requires a customer-centric mind-set and a new training approach.

**ADMINISTRATION**

Smarter tools and automation will massively reduce back-office work. Streamlining and digitization will mean managers won't have to work through long paper lists and daily reports. The new checkout experience will also minimize hassles such as cash management.

*Potential reduction of labor hours: 60+%*

# FRESH OR FAIL

## SIX KEYS TO WORLD-CLASS FRESHNESS

Grocers are under renewed threat as online retailers ramp up their food options. But traditional food stores still have a vital card to play: freshness. Customers like seeing and experiencing food before they buy it, potentially giving physical stores a huge advantage. In our experience, moving from average to best in fresh food can drive a rise in supermarket revenues of up to 10 percent.

That gain is by no means automatic: Many customers are dissatisfied with grocers' current fresh offerings. So, to take advantage of the opportunity, retailers must optimize the journey food makes "from farm-to-fork."

Exerting control of quality means, first, working with the ultimate suppliers – everything from fruit farmers to fishermen. Crucially, it entails minimizing the time spent at each stage of the supply chain and making sure the products are kept in the right conditions. Temperature control needs to be rigorous and enforced by effective, risk-based quality checks. Retailers can also increase freshness by getting deliveries of the right quantities of food at the right time, so that it spends less time on shelves. In order to do so, retailers need to use the most sophisticated approaches available today, such as demand forecasting based on seasonal fluctuations and customer behavior in individual stores.

Presentation is also a critical element of freshness. Piling fresh fruit and vegetables high may look good but also brings the danger of spoiling if they do not sell quickly enough. So it is better to allocate shelf space according to how well individual items sell by store. Grocers can also generate additional revenue from a dynamic assortment that seeks always to give customers something new to discover.

To implement these ideas, grocers will need to change the way they work internally, as well as with their partners. If suppliers have better access to data from retailers' forecasting systems and advance information about promotions, for example, they can organize their production more effectively to deliver fresh produce and reduce waste. However, these efforts will only work if staff work as an integral part of this process and embody a culture of freshness. Managers need clearly defined best-practice processes combined with intensive hands-on training to make them recognize the advantages of the new ways of working and encourage their staff to follow suit.

# COMBATTING THE ONLINE CHALLENGE

Online retailers of everything from fashion to furniture have reached double-digit shares of their markets. Food is an exception, and many consumers still view online offers with a skeptical eye. A recent Oliver Wyman survey conducted in Europe found that a lack of trust in the quality of products kept 44 percent of the respondents from ordering fresh goods online. Higher prices and inconvenient delivery times also put them off. As a result, online retailers still only have a very modest share of the market – a mere 1 percent – making fresh food perhaps the last bastion of a brick-and-mortar retail competitive advantage.

But things can change fast, and online grocers will almost certainly succeed in breaking down such barriers in the medium term. To date, the vast majority of online competitors have focused on dry goods and non-food. Now – led by Amazon Fresh – they are launching an assault on fresh food, with Germany as a crucial battlefront. Amazon launched its first online supermarket there in 2015; today, its prices are scarcely different from those of grocers, even on fresh offerings. Thanks to its partnership with parcel distributor DHL, the internet

giant already offers convenient time slots in a number of German pilot cities. Amazon Fresh will soon be available in other major cities, and achieve extended coverage in the country over the next few years.

What is happening in Germany will soon come to other European markets. And in the United States, it is already a fact of life; with the recent acquisition of upscale brick-and-mortar Whole Foods chain, Amazon is entering the mainstream. By 2020, online retailers' share of the food market could quadruple or more, to between 4 and 6 percent, putting at least 15 percent of full-range retailers' brick-and-mortar stores at risk. (See Exhibit 1.)

Notwithstanding what seems to be an inexorable trend, traditional grocers can fight back, and even thrive, if they play to their natural strengths in fresh. Despite today's digital environment, consumers still appreciate the advantages of shopping in a real store. Sumptuous cheese and meat counters, freshly picked fruit and vegetables, and the scent of fresh bread are still luring customers to grocers week after week. And as long as customers are satisfied with the quality of a store's fresh products, they will be difficult to convert to online. Crucially, these happy customers tend to buy not only more fresh but also more ambient and non-food products – up to one-third more.

**Exhibit 1: Online retail is primarily a threat to full-range retailers' store networks**
Food retail stores in Germany: profit simulation based on a 5% online market share
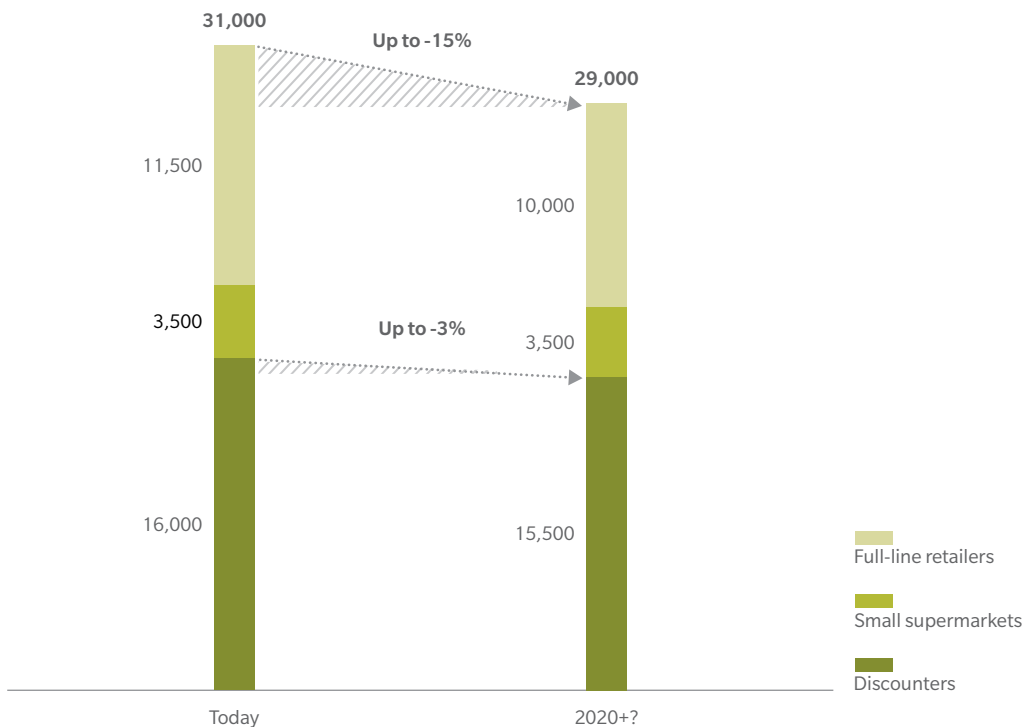


**Source:** Oliver Wyman analysis

# A SIX-STEP PROGRAM FOR OPTIMUM FRESHNESS

How can retailers achieve a quantum leap in freshness? To date, many have focused on optimizing individual functions such as buying and logistics. For example, buyers tended to concentrate on selecting suppliers to secure availability while logistics staff focused on minimizing delivery cost to stores. Further, stores attempted to manage the balancing act of ensuring availability while minimizing shrink. The result is local optimization of individual functions but a sub-optimization of the system as a whole. This approach tends to yield only gradual progress, not enough in a competitive environment challenged by disruption.

Our experience suggests that a dramatic step forward in fresh performance can only be achieved by an approach whose scope stretches from farm-to-fork; here, the system is optimized rather than just the functional units. We have found that this is the only way in both the short and long term to drive gains.

This journey towards world-class freshness is a significant one, and it consists of six steps. (See Exhibit 2.)

Exhibit 2: "World-class fresh" requires good teamwork

| | | |
|---|---|---|
| **1** | OPTIMUM PRODUCT QUALITY UP TO THE SHELF | • Product specifications<br>• Quality assurance processes and systems<br>• Temperature control right up to the shelf<br>• Consistent standards across the supply chain |
| **2** | THE RIGHT QUANTITIES AT THE RIGHT TIME | • Forecast accuracy<br>• Integrated supply chain with integrated merchandise planning<br>• Store ordering processes and tools<br>• Short ordering lead times for the stores |
| **3** | THE PERFECT ASSORTMENT FOR EACH STORE | • Local adjustments to each store's assortment<br>• Leading regionality and locality, as well as a culture of assortment innovation |
| **4** | OPTIMUM PRESENTATION | • Right space allocation for each department and item<br>• Service staff, as appropriate<br>• Optimum packaging/order units |
| **5** | SUPPLIER COLLABORATION, NOT CONFRONTATION | • Integrated view on the supply chain (cost, speed)<br>• Exchange of data and best practices<br>• Partnerships/vertical integration |
| **6** | EXCELLENT IMPLEMENTATION IN THE STORES | • Rigorous customer- and quality-centric culture<br>• Best-practice process standards, simple tools & aids, and training sessions<br>• Fair targets and incentives for each store |

Source: Oliver Wyman analysis

## OPTIMUM PRODUCT QUALITY UP TO THE SHELF

Fresher products on the shelf have greater appeal to customers, which boosts sales and reduces waste. Optimum product quality is the result of seamless operation along the entire supply chain. To achieve this, strict supplier management, rigorous standards, and effective, risk-based quality checks in the incoming goods department are needed.

For example, for fresh pioneers it makes no sense to keep products at the right temperature until arrival at the store, only to leave them for hours in the incoming goods area or in the aisles at the wrong temperature. But ensuring fresh does not stop at the store. Some best-practice supermarket chains even communicate with customers to inform them on how best to store a product at home so it does not spoil prematurely. The factors influencing customers' experience of product quality are many and multifaceted – coming to grips with them can only be done in an interdisciplinary fashion. (See Exhibit 3.)

## THE RIGHT QUANTITIES AT THE RIGHT TIME

A smarter ordering process with shorter lead times and integrated goods flow control can dramatically increase the freshness of a retailer's products nationwide. This typically requires an upgrade of hardware and software throughout the value chain.
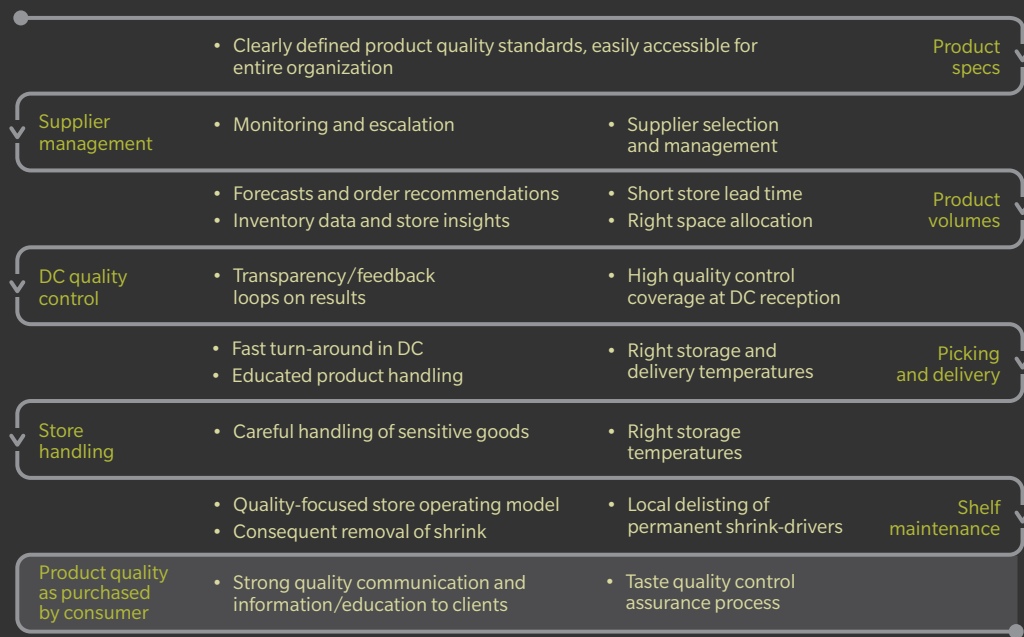
New technologies, including machine learning and recurrent neural networks, are already providing a leap in forecast quality and, consequently, in-store volume planning. These approaches go beyond data on sales at a particular store, and include information such as weather forecasts that can help predict the demand for individual products. (See Exhibit 4.) Order data is fed into an integrated goods flow control system, which integrates information from category management, logistics, and sales.

Speeding up the store's order and delivery rhythms and reducing delivery times almost always has a dramatic impact on freshness performance. If the ordering lead time for meat products is reduced from 36 to 24 hours, these products are fresher on the shelves and waste decreases typically by more than 20 percent. So it makes good sense to have different delivery schedules for different stores, depending on when customers usually shop. Switching deliveries of fresh products from early morning to early afternoon in some stores drives maximum sales readiness at peak shopping hours and, in our experience, can generate more than 20 percent additional revenue.

## THE PERFECT ASSORTMENT FOR EACH STORE

Local factors have a significant impact on demand, and grocers are in a good position to take advantage of them. Shops in certain places will face surges on Mondays and Fridays from weekly family shopping trips. Local demographics have a major impact too:

## Exhibit 5: Product quality and freshness needs a multi-disciplinary approach

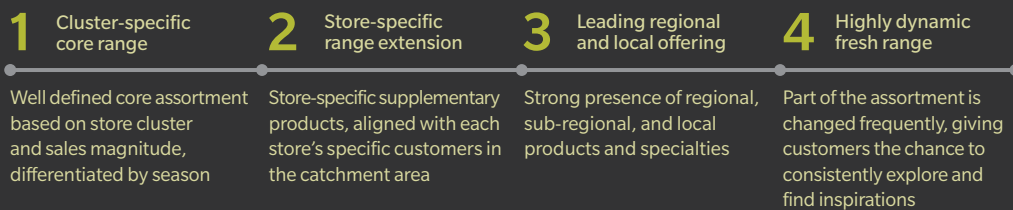| | | | |
|---|---|---|---|
| | • Clearly defined product quality standards, easily accessible for entire organization | | Product specs |
| Supplier management | • Monitoring and escalation | • Supplier selection and management | |
| | • Forecasts and order recommendations<br>• Inventory data and store insights | • Short store lead time<br>• Right space allocation | Product volumes |
| DC quality control | • Transparency/feedback loops on results | • High quality control coverage at DC reception | |
| | • Fast turn-around in DC<br>• Educated product handling | • Right storage and delivery temperatures | Picking and delivery |
| Store handling | • Careful handling of sensitive goods | • Right storage temperatures | |
| | • Quality-focused store operating model<br>• Consequent removal of shrink | • Local delisting of permanent shrink-drivers | Shelf maintenance |
| Product quality as purchased by consumer | • Strong quality communication and information/education to clients | • Taste quality control assurance process | |

## Exhibit 3: Accurate weather forecasting can be a key factor in determining success in fresh
Impact of weather on forecast accuracy. Example: German Bratwurst

MEAN FORECAST ERROR (%)



Weather-adjusted forecast

Original forecast

CALENDAR WEEK
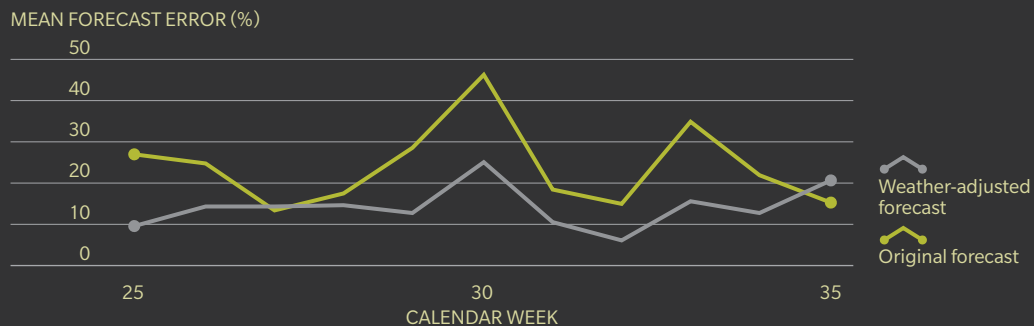
Other success factors include:
- Seasonality and trends
- Holidays and events
- Promotions and price changes
- New and discontinued products
- Cannibalization
- Weather impact

## Exhibit 4: Four key elements enable a "quantum leap in the approach to ranging in fresh"

**1** Cluster-specific core range

**2** Store-specific range extension

**3** Leading regional and local offering

**4** Highly dynamic fresh range

Well defined core assortment based on store cluster and sales magnitude, differentiated by season

Store-specific supplementary products, aligned with each store's specific customers in the catchment area

Strong presence of regional, sub-regional, and local products and specialties

Part of the assortment is changed frequently, giving customers the chance to consistently explore and find inspirations

High-income areas will have a greater appetite for pricier offerings, and, if there is a large proportion of ethnic shoppers in an area, demand for corresponding products will be high.

More important in future, however, will be the insights that big data provides into what people actually want to buy and when. This allows individual stores to arrange direct deliveries of seasonal goods from local farms and suppliers that will make it stand out competitively. A dynamic assortment is exciting and increases the likelihood that customers will discover something new, like it, and come back. (See Exhibit 5.)

The ability to adapt a product range to local circumstances represents a fundamental competitive advantage for full-range retailers versus discounters and online retailers. This is a "trump card" that should not be underrated, and retailers are well-advised to play it more often in individual stores, especially in the fresh goods segment. Typically, grocers have focused primarily on such factors as local disposable income, with mixed success – with good reason. The demand for foods and fresh products is much more complex; understanding and adapting to specific local factors can have a massive positive effect.

## OPTIMUM PRESENTATION

Many fresh managers still stick to the rule of thumb "pile them high and watch them fly", especially for the presentation of fruit and vegetables. But there is always the danger of a rapid fall in quality at the bottom of the pyramid. Optimum, modern-style presentation starts out by adapting the size of each department and product display to reflect its revenue contribution in a particular store. Appropriate order units can then be introduced, avoiding excessively large batch sizes, which can be a significant driver of wastage. Skillful presentation, on the other hand, can nonetheless give the impression of abundance even when a store has minimal quantities of a product.

## SUPPLIER COLLABORATION, NOT CONFRONTATION

Get together twice a year, fight over commercial terms, then go back to your workplace and continue your own work. Rituals like these between buyers and suppliers are increasingly outdated in a digital age. Our experience is that retailers alone could save billions by increasing the quality of their fresh products through better collaboration with their suppliers.

Grocers need not only to be aware of the extreme fluctuations in demand – and, to some extent, supply – that suppliers face, but also to help them deal with these fluctuations. In the absence of good information on such things as changes in assortments or spikes in demand driven by promotions, suppliers are forced either to maintain high inventory in their warehouses or insist on long lead times for deliveries – understandable, but in both cases freshness and/or availability suffers.

# PHYSICAL OUTLETS HAVE REAL ADVANTAGES – AN OLIVER WYMAN SURVEY

Traditional brick-and-mortar stores have natural advantages over online competitors, a recent Oliver Wyman survey reveals – but grocers need to be careful not to squander their head start by neglecting important details.

We recently surveyed over 1,000 European consumers; the results indicated an enduring affinity for the hands-on experience of fresh food shopping. Not being able to touch and choose an individual product features at the top of the list of reasons not to shop online. Indeed, three out of four respondents indicated this is their most important reason for shopping in brick-and-mortar stores in the future.

In addition, 68 percent of those surveyed placed major importance on being able to take products away with them immediately. (See Exhibit 6.) A lack of confidence in product quality

**Exhibit 6: Reasons why customers continue to buy in supermarkets**
Question: "What are the main reasons for you to continue buying fresh goods in physical food retail stores?"

**76%**    I can touch and pick the products

**68%**    I can take the products with me straight away

**42%**    I like to buy food in the supermarket

**36%**    I like the bigger selection in supermarkets

**20%**    The product quality is better in the supermarket

**11%**    I like the personal advice in supermarkets

Source: Oliver Wyman survey of 1,000 consumers in May/June 2017

kept 44 percent of respondents from ordering fresh goods online – even more so than higher prices and long delivery times. (See Exhibit 7.) Despite this good news, there were some worrying signs for brick-and-mortar grocers. Better quality and in-store availability – considered by many to be the key advantages for physical stores – appeared to be diminishing in importance. Only one participant in five cited superior quality and only one in ten mentioned in-store advice as a key reason to buy from a brick-an-mortar provider. Most worryingly, more than 80 percent of all customers indicated disappointment with the quality of fresh products at their grocers, even though 58 percent admitted to having bought poor-quality goods. Despite this level of dissatisfaction, only a fifth of unhappy customers actually complained at the store, so retailers are likely to be unaware of the true scale of the problem.

This opens the door for online offers, especially if the quality is convincing. In fact, customers in our survey indicated that they would buy up to a quarter of their fresh food needs on the internet if they felt they could get the same, or nearly the same, quality as is available in supermarkets.

In summary, consumers confirmed that brick-and-mortar grocers are still first choice for their fresh needs. But the head start versus online is eroding.

**Exhibit 7: Reasons why customers do not order fresh goods online**
Question: "What are the main reasons preventing you from buying fresh goods online (again) today?"

**44%** I don't have enough trust in the product quality

**34%** Delivery takes too long

**32%** The products are more expensive than in the supermarket

**19%** The initial effort is too big (opening an account, etc.)

**13%** I don't have the possibility to buy online

**11%** The selection isn't big enough

**7%** I am afraid of data abuse

**3%** I have had some negative experiences in the past

Source: Oliver Wyman survey of 1,000 consumers in May/June 2017

By collaborating more closely, retailers can enable suppliers to forecast these fluctuations and organize their production around them. This could be done by letting suppliers have access to data from retailers' forecasting systems or giving them advance notice of promotions. Retailers can also substantially accelerate their processes and, ultimately, improve their level of freshness if they review current quality requirements and controls, and coordinate them with their suppliers.

## EXCELLENT IMPLEMENTATION IN THE STORES

All of a store's efforts to perfect its fresh offering will go up in smoke if employees do not practice a culture of excellence every single day. For the best performers in fresh, this has meant new ordering processes, planograms, and key performance indicators (KPIs), which fundamentally transformed the work of store managers and fresh managers. This has been achieved through comprehensive best-practice programs and intensive hands-on training, ensuring that managers and associates recognize the advantages of the new ways of working and can implement them.

For these freshness leaders, new KPI systems constantly provide managers and their teams with information about the store's fresh offerings, and play an integral role in outcome-based incentive systems. A key lesson has been not to define companywide average targets, because the differences between stores are too great. A better approach is to differentiate targets by store, taking into consideration such factors as the size of the store and its catchment area; fair targets motivate more than impossible-to-reach ones. Such a KPI-based culture can also help to improve performance by creating transparency about which stores are performing particularly well, and transferring their best practices to other stores in the network. A culture centered on quality and customers will benefit everyone with a stake in the supermarket: customers, staff, and the retailers themselves. (See Case Study.)

# CONCLUSION: BETTER FRESHNESS INCREASES REVENUE

Retailers who can persuade customers that their fresh products are of the highest quality will not only find a highly effective way to ward off growing online competition but also have a source of often dramatic incremental revenue and increased customer satisfaction.

The emerging winners in fresh have all recognized the scope of the farm-to-fork challenge, and addressed it an integrated and multifunctional fashion. They have been rewarded with extraordinary increases in customer satisfaction, like-for-like growth, and margin enhancement. It is a challenging path, but one well worth treading.

# GOING DIRECT TO CONSUMERS: PROMISES AND PITFALLS

## DIGITAL CHANNELS ENABLE CLOSER ENGAGEMENT WITH CONSUMERS. BUT IMPLEMENTATION IS HARD AND NEW RIVALS LOOM

After selling their products through retailers for most of the last century, consumer packaged goods firms are finding other ways to reach consumers. New direct routes to market, with a wide spectrum of approaches, are helping companies put the consumer back at the heart of their strategies.

Many are diving in, but they are about to face new, sometimes unexpected, challenges. The process of selling directly to – and reconnecting with – consumers is a subtle, complex one, as testified by numerous failures and half-successes. However, it is possible to assess the challenges through strategic and operational lenses, figure out the challenges, and find ways to overcome them. Firms must be realistic about their current capabilities – those it will need to build and the changes in operations this implies. They must be prepared for the wide-ranging transformation, as only those firms that realize the scope of the changes needed will be successful and claim the big prizes out there.

# NEW CONSUMER BEHAVIOR – USING NEW CHANNELS AND TECHNOLOGIES

The need for new ways to engage comes from major changes in consumer behavior, the channels used for shopping, and the technology that drives these channels. Consumers are increasingly demanding and self-aware, especially younger and higher-income shoppers, and they bring both challenges and opportunities for makers of packaged goods.

They shop anywhere, anytime, for anything, through whatever device they find most convenient. A Uniqlo customer might browse product information on the company's official website with a PC at home and add something to their cart. Then they might pay via smartphone on the way to a party, and pick up their purchase – already packed and ready – from the nearest Uniqlo store.

Consumers are no longer excited by traditional mass offerings, and are instead demanding personalized or curated recommendations, promotions, and products. The "Share a Coke" campaign, in which consumers can buy a Coke with someone's name on the bottle, helped to boost Coca-Cola's volumes by 0.4 percent after more than 10 years of steady decline. Shoppers' expectations have risen, and they want better service, access to more information, and a great experience. AB InBev recently introduced Oculto, a tequila-infused beer that utilizes smart label technology: Touch the bottle, and an LED comes on. Scan the label with a smartphone, and the customer is connected to an app where they can interact with the brand and win prizes. So, the experience goes beyond the product.

## Exhibit 1: Online retail as a percentage of total retail, and share of mobile

E-COMMERCE AS % OF TOTAL RETAIL
2016

MOBILE SHARE (IN %) IN TOTAL ONLINE SALES
CHINA
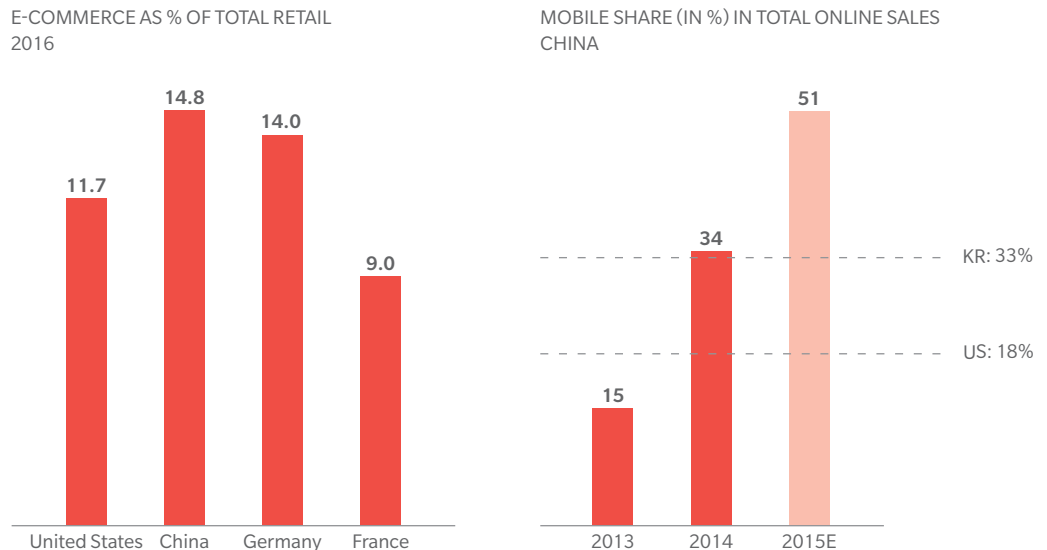


Source: iResearch, US Department of Commerce, Statista, Oliver Wyman analysis

Retail is moving online: Traditional brick-and-mortar retailers have been valued as intermediaries to select and deliver products, but perception of this value is fading. There are extreme differences in speed from country to country, with China now leading the pack, but globally more people are turning to online channels to find what they are looking for at their fingertips. Consumers are also relying more on trusted recommendations from their social networks, and sharing their opinions through channels such as Facebook, Twitter, and WeChat.

Business-to-consumer online platforms – such as Tmall, JD, and Amazon – have now surpassed consumer-to-consumer – the likes of Taobao and eBay – in terms of gross merchandise volume. Business-to-consumer is expected to increase its share of online business from around 50 percent today to over 70 percent in 2020. The smartphone has gradually outgrown the PC as a tool for online shopping, and it is still gaining share, especially for impulse purchases. In China on November 11, 2017 (Singles' Day, an annual shopping event) 90 percent of sales were carried out by mobile phone, up from 82 percent in 2016. However, PCs are still irreplaceable for expensive, one-off purchases that require detailed research and a comparison of different vendors.

A dynamic, innovative digital ecosystem has developed through improvements such as advanced robotics, radio-frequency identification tagging, wireless checkout, and alternative and virtual reality. These have created new ways for consumers to interact with brands and to understand and experience products. Mobile apps can help promote aspects of a business such as its history, brands, expertise, products, and events, providing new ways to engage with more consumers. Automated ad-buying software creates opportunities for location-enabled mobile advertisements. These can target consumers who are close to brands' retail locations. You can now search a product on Taobao using a picture of the product you are looking for. Products can be conjured up in virtual reality, so that users can see them in a semi-natural environment through headsets. Customers can test make-up products on a photo of themselves. Costs can be reduced through machine learning to optimize ad campaigns as they are underway – changing the audience or ad content, for example. Low-cost bots can answer consumers' questions.

## DID YOU KNOW?

Amazon's mobile app gets around
**75,000**
new downloads every day in the United States

**80%** of JD.com transactions in China are on mobile phones

Facebook adds
**500,000**
new users every day – six new profiles every second – and users spend an average of 20 minutes per day on the site
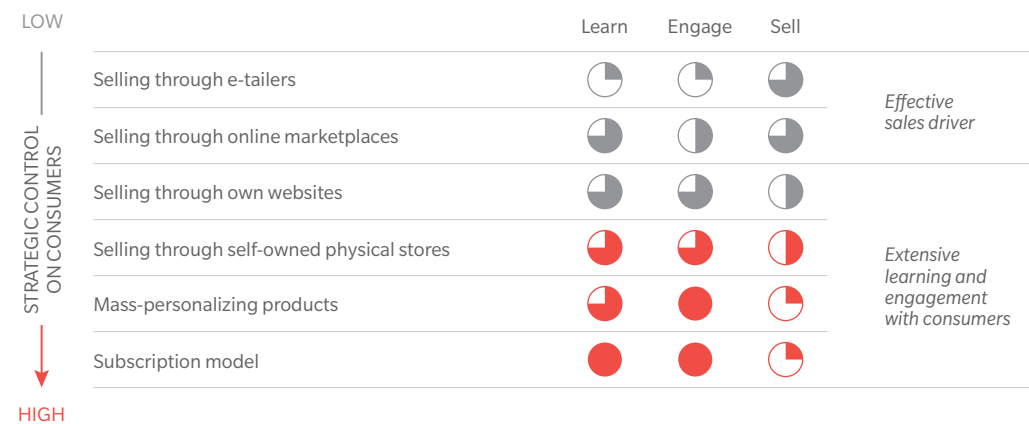
WeChat users check the app
**23**
times a day on average

# GOING DIRECT TO CONSUMERS

These changes are driving consumer goods companies, which have traditionally been product-centric, to focus more on consumers. Firstly, they are trying to learn more: where and how people search and browse, what and how they buy, and how these habits are changing. These insights will inform future product development and help identify the most effective selling levers. Secondly, they are engaging more with consumers, by using more touch points – both traditional and digital – combined with data and analytics. By reinforcing their connection and interaction with consumers, they will be able to raise brand awareness and reputation, as well as customer loyalty. Thirdly, direct-to-consumer channels will help to sell more products, boosting revenue growth, margins, and market reach. (See Exhibit 2.)

**Exhibit 2: A number of approaches adopted by fast-moving consumer goods (FMCG) companies to "go-direct"**

| STRATEGIC CONTROL ON CONSUMERS (LOW → HIGH) | Learn | Engage | Sell | |
|---|---|---|---|---|
| Selling through e-tailers | ◔ | ◔ | ◑ | *Effective sales driver* |
| Selling through online marketplaces | ◑ | ◑ | ◑ | |
| Selling through own websites | ◑ | ◑ | ◑ | |
| Selling through self-owned physical stores | ◑ | ◑ | ◑ | *Extensive learning and engagement with consumers* |
| Mass-personalizing products | ◑ | ● | ◔ | |
| Subscription model | ● | ● | ◔ | |

Source: Oliver Wyman analysis

These goals imply more direct connections between companies and consumers. We see six major approaches. They vary in their level of strategic control over consumers and the degree of emphasis on the above three objectives.

Selling through e-tailers is almost the same as conventional distribution, as the retailer owns the goods. But consumer goods companies often report these revenues in a separate e-commerce category in annual reports and other formal publications. This approach has the lowest degree of strategic control. Examples include selling on Amazon in the United States and JD.com in China. A consumer goods brand can set up an online store, or marketplace, through a large platform such as Tmall. The operation of the online store is either outsourced to a third party, such as an external Tmall partner, or handled directly by an in-house Tmall partner. This kind of platform has been the source of most of the growth in online sales in China.

A self-owned website can provide customers with product information and carry out marketing campaigns. Nestlé Marktplatz, for instance, lets German consumers explore and buy 72 Nestlé brands, including products that have yet to reach stores such as Baci Perugina chocolate pralines from Italy and extra-spicy Maggi chili sauce from Malaysia. The marketplace also acts as a forum for conversations among customers, who rate and comment on products, seek advice, and share ideas – as well as between the producer and customers. Customers will thus act as brand advisors who contribute ideas and suggestions for new products, packaging, and ways to use the products.

A more traditional approach is standalone, self-owned brick-and-mortar stores, which sometimes complement a digital presence. LEGO has about 130 retail stores worldwide, with iconic features such as the pick-a-brick wall, where builders of all ages can select individual LEGO bricks for their projects. They also feature Digibox augmented-reality cameras, which allow shoppers to scan product boxes and see features of a particular LEGO set come to life. The stores host monthly mini-build events, as well as LEGO Club meetings for paid-up members. They host the LEGO VIP program, which lets members purchase new sets before their general release, and awards points for every dollar spent. Other LEGO channels include Legoland, a chain of family theme parks, and an online store for customer interaction and marketing. There are also plans to open LEGO House, a kind of museum in which consumers can find out more about the brand and new ways to play with LEGO bricks.

Mass personalization lets customers put their names on a product and contribute to its design. On the Nike homepage and in the Nike+ app, people can design a shirt or hat for Nike to manufacture. Nike also sends users a feed of stories based on their interests, and offers them personalized training tips from an expert. So far, however, mass personalization has mostly been adopted as a marketing concept to create buzz, and it has not often produced a good return on investment at scale.

In the subscription model, companies ensure delivery of a product to customers, giving the service providers the highest form of strategic control through a relationship and recurring revenue. The Dollar Shave Club (DSC) started out in 2012 as a subscription razor service, offering substantial savings by avoiding the costs of traditional retail distribution. DSC offers three types of razor cartridge, ranging in price from $1 to $9 a month, and it has gained significant market share from market leader Gillette. DSC then expanded into the broader men's grooming category, and was acquired in 2016 by Unilever for $1 billion.

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HOW MANY LEGO BRICKS DO YOU THINK EXIST IN THE WORLD? MILLIONS? BILLIONS? HOW ABOUT HUNDREDS OF BILLIONS?



According to LEGO's website, there are **86** LEGO bricks for **every person** on the planet

# NEW OPPORTUNITIES, NEW HAZARDS

Each consumer product category has its own characteristics and dynamics, so companies will have to judge which channels are right for which products, and run different business models in parallel. Each kind of channel comes with its own opportunities and challenges.

Homecare products such as laundry detergent and tissue paper may work well through online channels. Fashion apparel and accessories may do better with an omnichannel approach, as many consumers still want to touch and feel the products before purchasing. Brands such as Warby Parker and Outdoor Voices, which started out by building online shops, are opening brick-and-mortar locations, underlining the value consumers find in physical stores.

Three Squirrels was launched in China in 2012 as a purely online brand of nuts and snacks, and it operates self-owned web-stores on major marketplaces, including Tmall and JD.com. It has been the top online brand in the snack category since 2012, and reached 1 billion renminbi in sales in 2014. But it later opened a physical store in Anhui province, which achieved sales of 2.4 million renminbi in its first month, or 8,000 renminbi per square meter of store space. This and subsequently opened stores are equipped with amenities and brand experience areas to promote the brand image. Three Squirrels announced it would target 100 stores by the end of 2017.

Challenges from online channels will include the lack of a strategic barrier in the form of shelf space in brick-and-mortar stores. This space was mostly guaranteed long term in old models thanks to negotiations with retailers, and it offered tremendous protection

Exhibit 3: Factors influencing category "Going Direct" potential (non-exhaustive)

| LOW | | GOING DIRECT POTENTIAL | | HIGH |
|---|---|---|---|---|
| Tooth brush | | Low value vs. high value | Cell phones | |
| Chewing gum | | Impulse vs. stocking up | Printer ink | |
| Paper towel | | Commodity vs. unique value prop | Cosmetics | |
| Toilet cleaning | | Low purchase frequency vs. high | Coffee/Drinks | |

Source: Oliver Wyman analysis

to the brands. However, this barrier does not exist when the "shelf" is online, and new entrants with innovative business models and differentiated capabilities can appear and gain share rapidly.

Selling via online retailers will be different from dealing with chains of brick-and-mortar stores. Until now, Unilever, P&G, and L'Oréal have dominated their respective markets worldwide, while the largest retailers have each covered only a few countries: Only a handful of retailers have been significant in both North America and Europe. However, Amazon has become the leading e-commerce platform in most of the countries it operates in, with China being the exception. That means brands will need to define strategies and tactics to negotiate with the largest retailer worldwide.

Finally, product makers that go fully direct will find themselves closer to the fire when customer expectations are not met. In the past, retailers absorbed risks such as products being unavailable or damaged, and they also handled customer service and exchange policies. So they dealt with unhappy customers and the associated contagion risks. Consumer product companies will find being on the frontline a new experience. One leading global manufacturer of homecare and personal care products established a flagship store on a major business-to-consumer platform. However, this was the first time it had dealt directly with consumers, and it struggled to build the right product range, run accurate forecasts for promoted items, and create efficient plans for online promotions. This resulted in a mixture of excess stock of obsolete products and shortages of products in demand, which damaged sales and margins.

# START PLANNING

Consumer packaged goods companies have a great opportunity in direct-to-consumer sales, but they need an overarching strategy and a clear idea of what they will gain. One condition is an understanding of the true profitability of the different channels to be developed, even amid a variety of hidden costs and benefits. Once they have this, they can refine business models for operational readiness, cost efficiency, and smooth relationships with existing partners.

Another condition is new capabilities and skill sets. If the main purpose is to extract value and insight from immediate access to customer-level transaction data, the company will also need to make business decisions based on these insights. Most consumer goods companies still report internally on monthly sales, but online platforms track sales by the minute. That will mean staff work in a faster environment and need skills such as big data and analytics, omnichannel expertise, and supply chain management. Above all, this will be put in place by the company leadership, which must align the entire organization and make sure it is ready to embrace the culture of selling directly to consumers.

# SMART FASHION

EXPLORING HOW TRADITIONAL FASHION PLAYERS CAN ADOPT WINNING PARTS OF THE FAST FASHION MODEL WITHOUT THE *FAST*

Fast fashion has revolutionized apparel by delivering new, highly fashionable products at low prices in incredibly short lead times. The buzz can make traditional branded apparel companies – wholesalers or vertically integrated retailers – feel like they are falling behind and may never catch up, saddled as they are with global supply chains optimized for scale rather than speed and flexibility. Attempts at radical change in their organizations and working methods may only prove harmful.

We propose a different model that can work better for traditional apparel players: "smart fashion." This model builds on some of the key principles that underlie the success of fast fashion but do not often receive the same hype. They can help traditional players gain many of the benefits of fast fashion without overhauling their companies from the ground up.

## THE BUZZ AROUND FAST FASHION

Fast fashion has been around for decades since its emergence in Europe, but its global success has grown exponentially over recent years, raising awareness of its competitive threat to more traditional apparel retailers in the US. Fast fashion is a supply-chain driven operating model that delivers very short product lead times: Clothes often go from runway to shelf in a matter of weeks – or even days. Fast fashion companies can respond more quickly to in-season trends, differentiate their assortment better to reflect local tastes, and substantially reduce the amount of merchandise requiring mark-down and obsolescence.

**Despite decades of success, fast fashion's interest level has grown exponentially in recent years**

PERCENTAGE OF SEARCHES RELATIVE TO JULY 2017



Source: https://trends.google.com/trends/explore?date=all&q=%22fast%20fashion%22
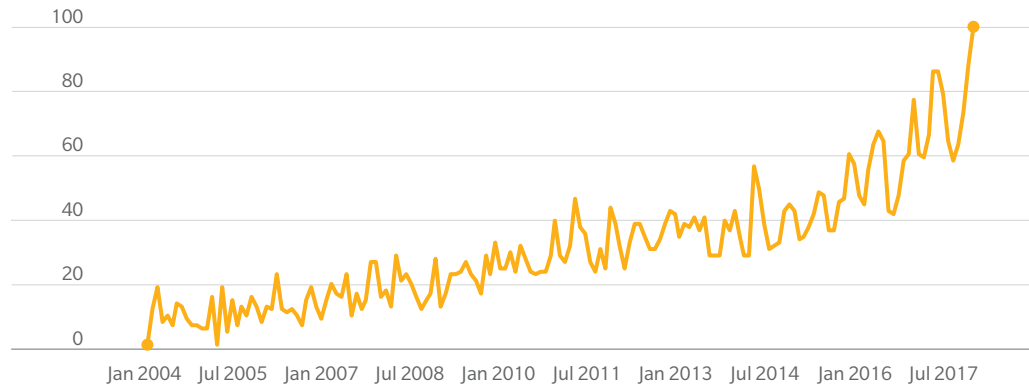
But fast fashion is not for everyone. Many traditional branded apparel wholesalers and vertically integrated specialty retailers feel that they cannot afford or do not want the costs and risks of a complete redesign of their supply chains. For these players, our experience suggests there are still highly effective ways to improve time to market and supply flexibility in order to evolve along with consumer preferences without upending the existing supply chain.

The key is not to throw out legacy structures, but instead to learn from the fast fashion model, selectively applying some of the key concepts that receive less acclaim but are integral to fast fashion's success. This hybrid approach, which we call smart fashion, can improve marketplace and financial performance through four key elements.

## CHERRY PICK FROM FAST FASHION

From the outside, it may look as though fast fashion players are constantly turning over their entire assortment of new, trendy products and replacing them with even newer, trendier products – a feat that seems impractical to replicate. However, in reality, fast fashion players manage only a relatively small percentage of their assortment like this; our estimates suggest that less than half of the product on the shelf is designed and produced in-season. Instead, these players frequently inject new features and product versions into selected categories with high customer visibility. This gives the whole assortment a feeling of freshness that draws consumer interest.

To decide which product categories to manage on rapid turnaround, fast fashion players segment their assortment and focus obsessively on those areas that need to be on-trend and turned frequently. Smart fashion employs a similar tactic of segmentation. One critical

meta-question of self-evaluation is: "How well do we understand where our consumers demand fashionable products?" as opposed to other elements of the product offer, such as timelessness, quality, or price. The other is: "In those places where consumers do demand high-fashion products, how well do we understand what elements of fashion the customers seek?"

The importance of fashion compared with other qualities varies according to a range of factors, such as category and price points, and it ebbs and flows over time. Understanding which product attributes drive customer traffic and buying choices is vital. Today, women's athleisure is as much about fashion as function. Men's dress socks have emerged as the "new ties" – an item where fashion is as important as comfort for large groups of customers, if not more so.

Understanding which product attributes truly drive customer traffic and buying choices is vital. This is often referred to as a "consumer decision tree." Is "fashion" or "trendy" one of the top two priorities in the tree? Or are these both further down the list, below qualities such as comfort and the durability of materials? Vertically integrated retailers can use transaction data and product switching matrices to figure out how consumers trade off different product attributes against each other. Wholesalers can put their likely growing set of direct-to-consumer data to work, and also collaborate with key retail partners. They can then make fashion-centered investments in the categories that provide the most incremental benefit.

However, this limited application risks being overlooked by consumers. So, smart fashion players must also create a positive perception that associates the brand or brands with newness. One way is to launch products in limited runs, often in fashion centers such as New York, Los Angeles, Paris, and London. Those launches could reinforce fashion credibility and generate the buzz needed for a nationwide or global rollout. Moreover, the initial scarcity of the products could help drive up demand and sustain relatively high prices.

Exhibit 2: In-season developments
The impression of newness can be created with only a portion of the assortment developed in-season



Source: Oliver Wyman analysis

In a similar manner, wholesalers may elect to first launch a product in a single retailer (either a brick-and-mortar or online-only retailer) or just on their own e-commerce site, before later expanding to other channels. Other approaches from highly regarded brands include Victoria's Secret's nationally broadcast fashion shows. These are accompanied by marketing activities that create a perception of new, trendy products – even though few women actually wait online to buy the diamond-encrusted products shown at the events.

Armed with an understanding of their categories and consumers, smart fashion players can deploy clever brand association tactics. They can test new advertising or product concepts and act based on the consumer response. Remember: The consumer does not know – or care – what percentage of stock keeping units (SKUs) are new designs for that week or season, or how quickly the product went from design to shelf. What matters is that the consumer perceives something as fashionable and wants to buy it.

## LEARN FAST

Looking at fast fashion from the outside, too many companies seize upon the wrong word. They look at "fast" and think it means taking an entirely new idea, pushing it through the supply chain, and getting it into stores as quickly as possible – the runway to the rack in 3.6 seconds, so to speak. We argue that there is no inherent consumer value in this kind of speed. Even the most astute shoppers do not pay an additional cent for a product simply because it sped through the product development and production processes. They pay for fashion, which means on-trend products.

Still, "fast" does serve one vital goal: It reduces risk. Fast fashion is, at its core, a risk mitigation technique, enabling a company to place a large number of small bets and then respond in-season by doubling down on the items that really fly. Fast fashion companies do not just deliver fast; they are also fast learners. They study product performance closely and recognize, quickly, whether a product is a success or a failure, or requires some tweaks to make it a success. Conversely, traditional players have historically placed large bets on a few items, each of which has a high probability of success. However, as consumers become increasingly fickle and demanding – and as the competition ups the ante – success becomes harder to guarantee.

So, a key tactic for smart fashion players is to make a series of small bets on different products, colors, and fabrics. They focus on fast learning in a tight feedback loop, in which a small bet is made, consumer reaction is gauged, and action then taken accordingly. Losers can be discarded quickly and with minimal impact on the bottom line because the size of the original order was small. If a product is successful, companies can quickly produce more of it with the knowledge that it is a proven winner.
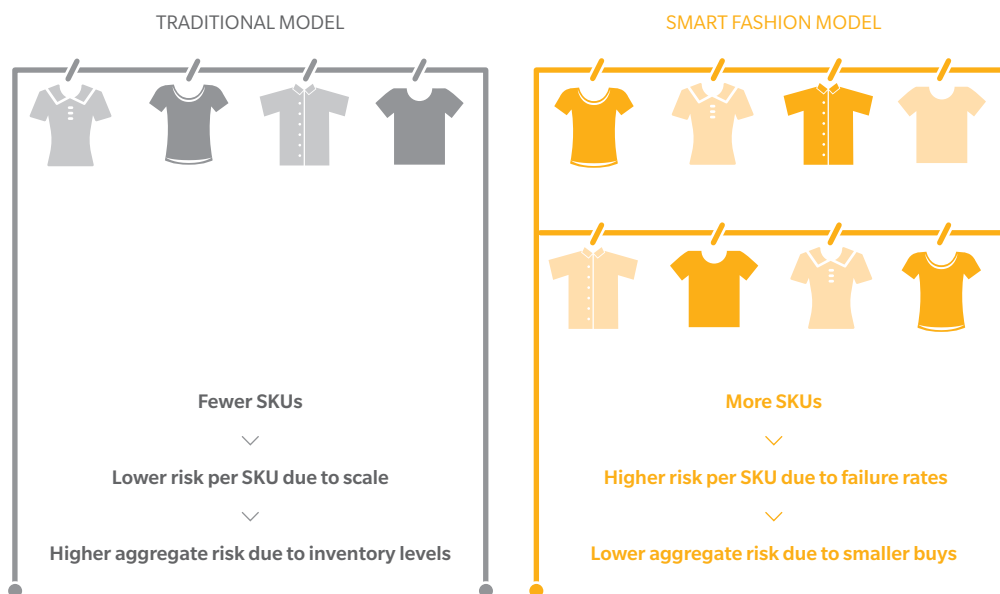
Traditional players often hesitate at this shift in mindset because it looks like it will be costly. However, in our experience, it is dramatically less costly in the long run to diversify the product

portfolio through more bets, and then follow up with further investments carrying high chances of success. Though a supply chain able to move product from needle to shelf in mere weeks may be beyond a traditional player's capabilities (and may also have diminishing returns), fast learning requires less-dramatic change and promises a greater return on investment. In this way, smart fashion gives a traditional player a new level of finesse and responsiveness.

**Exhibit 3: More, smaller bets**
Moving from traditional to smart fashion requires rethinking the per-unit and aggregate cost trade-offs

TRADITIONAL MODEL

SMART FASHION MODEL

**Fewer SKUs**

**More SKUs**

**Lower risk per SKU due to scale**

**Higher risk per SKU due to failure rates**

**Higher aggregate risk due to inventory levels**

**Lower aggregate risk due to smaller buys**

Source: Oliver Wyman analysis

# DRIVE DOWN COSTS

While product category segmentation and fast learning sound sensible to many companies, it is a challenge to execute them without blowing up the supply chain economics. All else being equal, the unit costs of numerous, more-frequent, smaller bets are higher than those in the traditional model, in which the supply chain has been set up to maximize economies of scale. Though our experience emphatically confirms the long-term financial advantages of smart fashion, companies should look for innovative improvements in efficiency at every turn.

Probably the most powerful way to reduce the costs of a greater focus on fashion is material leverage: the effective use of fabrics and materials across different products to achieve a "bundling effect." This increases volumes and, therefore, lowers costs – and it has been employed by the automobile industry for many years.

Smart fashion employs the multiplicative effect of sharing components to create newness with minimal cost

**30**

MATERIALS

**>7,700**

PRODUCT COMBINATIONS (SKUs)

Just as the entire portfolio does not need live, in-season developments to make a brand feel fresh, not all of a garment's components need to be new for consumers to find it new and fashionable. Often, a small embellishment – such as a seasonal color or print – can transform a product. These are light-touch changes that can be applied to existing patterns with very little alteration to the product specification and limited further testing. Vendors can often begin producing an updated product version the same day for minimal incremental cost.

These small tweaks can produce big differences. Consider a pair of jeans with six options for each of the following five components: main fabric, pocket lining, thread, clasp, and rivets. That makes more than 7,700 combinations, each one producing a unique version of the product. Even if only a tenth of those are technically viable, that is still hundreds of potential variations from just 30 material components.

Even if such a modular approach feels restricting to the creative team, this is a vital framework to limit material proliferation and costs. The materials purchased for these component changes can be used in the regular assortment of clothes too, further increasing economies of scale. Moreover, if designers can use excess or obsolete materials – from a weak product line, for example – write-offs can be avoided, and those materials can instead contribute to revenue.

The bundling effect of this use of materials also gives larger, traditional players an advantage over smaller start-ups, which cannot achieve such economies of scale.

## SMART ORGANIZATION

Smart fashion operates differently from the rest of a traditional apparel business, so the parts of the company that follow the approach must work differently too. They need different teams with different processes and targets – all geared toward enabling the prior three elements of the model. The profit and loss account (P&L) must be segmented to reflect the category segmentation between fashion and traditional. The team will operate with different metrics: For example, material costs per unit will likely be higher and quality standards

may need to be loosened. Revenue and expenditure must be separated so that the smart fashion teams can adjust quickly to frequent data showing the results of small bets on new product versions.

Teams working on a company's smart fashion projects will also need designers, merchandisers, and others who are well versed in these new products and processes. The team will be aware of brand associations, so they should work closely with the marketing department to foster positive perceptions around newness and fashion products. After product launch, they will be the driving force behind fast learning, as they identify new trends and quickly generate new product ideas.

The new processes, metrics, and terminology will feel uncomfortable at first, as they do at the initiation of any business venture, and we recommend that the smart fashion teams be given the freedom and mandate to operate differently. However, companies will need to keep the right balance. Smart fashion will not be completely separated like a digital start-up in an incubator. Instead, the smart fashion teams need to be part of the wider organization, so that effective communication can be maintained with the traditional parts of the business and the company as a whole can benefit from the economies of scale generated.

The organization will also need to be set up to promote the flow of information that smart fashion depends on. Zara, as an example, has empowered its store personnel by setting the expectations that they are the best source of customer intelligence, and learns from them daily by connecting them directly with designers and merchandisers at the corporate center. Many strong wholesalers and vertically integrated retailers lean on business intelligence for detailed performance updates. Wholesalers should maintain strong partnerships with select retailers and share data and viewpoints. Information from all of these sources can be employed to determine whether or not a new product should be expanded, tweaked, or eliminated.

# GETTING STARTED

Fast fashion appears innovative and radically different, and has received a great deal of publicity. But it can trigger different reactions. Some try to follow blindly without really understanding the details of the operating model, and they are liable to make costly mistakes. Others, dissuaded by the complexity of the changes needed, do not even try it. But ignoring the lessons of fast fashion can be even more damaging in the long run. Consumers increasingly want on-trend products at great prices, and fulfilling this demand represents a substantial opportunity. By understanding the key elements of fast fashion correctly, nearly all players should be able to create value from deploying some of its techniques. They will not be doing fast fashion though, but smart fashion.

# HEALTHCARE'S NEXT DISRUPTORS

## HOW CAN CONSUMER PACKAGED GOODS COMPANIES AND RETAILERS TRANSFORM DIRECT-TO-CONSUMER HEALTHCARE?
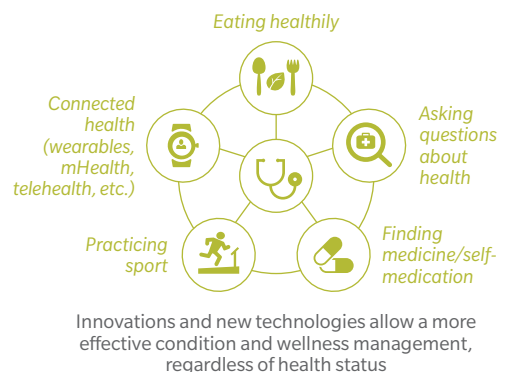
The rise of consumerism in healthcare is putting pressure on existing business models. It is also bringing about new outsized opportunity in direct-to-consumer categories. January's announcement from Amazon, JPMorgan, and Berkshire Hathaway clearly heightens this pressure. This groundbreaking news confirms for healthcare's biggest players that health and wellness is a major aspect of consumerism's future direction. As potentially industry-shaking partnerships such as this come to fruition, the question still remains: "Who is in the best position to stake a claim in this about-to-explode market?"

### Exhibit 1: Health 2.0 new paradigm: the consumer-driven health market

FORMER PARADIGM: **THE REACTIVE PATIENT**

Good health

Poor health

People used to worry about their condition only when they were sick and react accordingly

NEW PARADIGM: **A PROACTIVE CONSUMER**

Eating healthily

Connected health (wearables, mHealth, telehealth, etc.)

Asking questions about health

Practicing sport

Finding medicine/self-medication

Innovations and new technologies allow a more effective condition and wellness management, regardless of health status

Source: Oliver Wyman analysis

Healthcare is evolving from a sick-care market, treating people who are already sick, to a consumer-driven health market, with consumers taking more control of their own health and wellness decisions. We call this new paradigm "Health 2.0." (See Exhibit 1.)

Three main factors are driving this shift. Firstly, the costs of being sick are escalating, creating a major crisis for consumers who have not yet switched to more active management of their own health. Secondly, new technologies are empowering consumers. Multiple solutions like wearables and virtual care such as video calls with doctors are becoming more mainstream, allowing consumers to find alternatives to the traditional healthcare approach. Last but not least, governments and payers are encouraging this evolution because it reduces costs through preventive care and cheaper management of chronic conditions.

With this shift comes opportunity, especially in consumer healthcare products that are focused on areas like nutrition, healthy living, fitness, mental health, and better sleep. Recent innovations include foods that offer health benefits (for example, better digestion and healthier skin) and wearables that track fitness activity and sleep patterns. A future market of services and offerings will allow consumers to take charge of managing their vital signs, behavioral health, and wellness.

This consumer health market is predicted to double in size by 2020. This steep growth is, understandably, gaining the attention of different types of players – from traditional providers (pharmaceutical companies, hospitals, doctors) to retailers and consumer packaged goods companies (CPGs) – who all want their share of this significant opportunity. In other words, it is ripe for the taking.

# AN OPPORTUNITY PRESENTS ITSELF

Traditional providers may struggle to respond to this opportunity. They generally have not managed people's healthcare over multiple years, not because they do not want to, but because the incentives and profit model do not support this. As a result many have not developed refined capabilities in customer management or engagement. But the picture may not be so black and white; some forward-thinking payer and provider organizations are working successfully to engage with consumers outside healthcare's usual boundaries via non-traditional offerings.

In diabetes or heart disease, for example, some organizations realize successful outcomes cannot be achieved by only treating the problem reactively (that is, once the symptoms have appeared). They recognize the opportunities to engage consumers through everyday areas of contact (or "touch points") like nutrition, exercise, and social support by proactively managing health and preventing disease. Yet most of these healthcare organizations lack the infrastructure, consumer insights, and abilities to engage with consumers to implement this vision.

Meanwhile, new entrants, including digital tech companies, are bringing innovative devices and solutions to the market, forging relationships with consumers through things like biometric sensors and health apps. But, beyond the early adaptors – people who always like to be among the first to try a new product – not many consumers are aware of these start-ups.

Given the important role pharmaceuticals play in managing chronic conditions, they too have a vested interest in engaging consumers, but they are battling perceptions and negative press surrounding prices. Most people still view pharmaceutical companies as drug suppliers rather than health partners. And while these companies are good at advertising and promotion, getting consumers to ask a doctor about a specific drug is a meaningful step removed from actively engaging with consumers directly.

# ENTER CONSUMER PACKAGED GOODS COMPANIES AND RETAILERS

Our point of view is that the shortfalls of the traditional providers leave an opportunity for other types of players who have (i) customer touch points or ownership, (ii) consumer engagement skills, and (iii) consumer trust. These three dimensions are all core to the DNA of large food retailers and consumer packaged goods companies (CPGs). Interestingly enough, these players are being heavily disrupted in their historical markets by those that operate only on the internet ("pure players") and new technologies – but they now have an opportunity to become disruptors themselves.

With their existing footprint and deep understanding of consumer behavior, CPGs are well positioned to win in the health and wellness space. They have the marketing engine and consumer DNA to deliver a comprehensive (or "end-to-end") health experience in a way that the other players cannot. They already occupy space in the larger nutrition ecosystem and, perhaps more importantly, they are hardwired to understand consumers and help them improve their consumption behaviors. While ample attention is focused on how tech companies will disrupt healthcare, the reality is that CPGs already have the capabilities and footprint to own the consumer healthcare products space. They may just be sleeper disruptors – waiting until the right moment to lead the reinvention of healthcare.

The catch? Many CPGs broker in products (fatty, high-sugar goods and drinks) that directly contribute to poor health outcomes. To secure a strong foothold in this space, CPGs will have to prioritize healthier products, some of which will compete directly with existing lines of business. This will be challenging for some, as the quicker, easier return is in continuing to promote unhealthy decisions. But the long-term advantage of gaining consumer trust in this important market can pay dividends. This is the strategy set by Nestlé more than

10 years ago, with a progressive shift of its investments into its nutrition and health science line of business, which has grown at a faster pace than others. Categories like confectionery, prepared dishes, and ice creams have shrunk in size over the same period, showing a commitment to rebalance the overall company portfolio.

Retailers are also well positioned to seize the opportunity, but they face similar challenges. And some players have already made bold moves to promote health and wellness. A good illustration would be the CVS decision to stop selling tobacco products in 2014 because it conflicted with its purpose of helping people on their path to better health. Despite discarding a $2 billion annual business, CVS has managed to grow by double digits since then, thanks to a very effective rebranding strategy and alignment of its portfolio of products and services with its new purpose.

The pressing question for CPGs as well as retailers now is: "Can they evolve their business model to take advantage or will other players beat them to it?"

# THE FUTURE IS NOW

Health 2.0 is not theoretical. It has already taken root. According to a recent Oliver Wyman Consumer/Retail Healthcare survey, people are most interested in healthcare offerings that are convenient and personalized. Millennials, in particular, look for a wellness-focused experience. Their responses indicate that they expect to engage with the healthcare system in an everyday, potentially pleasing way rather than only during times of sickness; they want a health and wellness experience centered more on their day-to-day life than their occasional interactions with the traditional healthcare system. Exhibit 2 shows new needs emerging across the various patient touch point categories.

Leaders of CPGs are already addressing some of these emerging needs, building the foundations of what could become a significant disruption for traditional players. Danone, for instance, has established a strong early-life offering, through its early-life nutrition division. Although still focused mostly on the products it brings to market, it is increasingly positioning itself as a health partner committed to engaging with and nurturing mothers and babies. Meanwhile, Nestlé is investing in nutritional therapy through Nestlé Health Science. Since 2010, Nestlé has completed multiple strategic acquisitions and partnerships, including several medical food products. In January 2018, Nestlé announced the sale of its US confectionery business, further positioning it as a consumer health product company. In September 2017, the company announced two new acquisitions: Blue Bottle Coffee and Sweet Earth Foods, both eco-conscious brands, further materializing Nestlé's strategic business transformation towards nutrition, health, and wellness. And in January 2018, it emerged that Nestlé is taking the lead bid for Merck KGaA's consumer health business.

## Exhibit 2: Emerging and traditional offerings along consumer touchpoints in health (excerpt)

| CONSUMER TOUCHPOINT | TRADITIONAL | EMERGING |
|---|---|---|
| **Information and advice** | • Static repositories of clinical information<br>• Some patient-created content | • Guidance, advice, and navigation provided by third parties independent of the doctor |
| **Wellness and prevention** | • One-size-fits-all dieting and exercise advice<br>• Focus on aesthetic appearances | • Personalized diet management plans<br>• Real-time activity and behavioral monitoring<br>• Gamification of exercise/wellness |
| **Diagnostics** | • Doctor-led, post-symptomatic lab work and imaging etc. in clinical setting | • At-home diagnostics sent remotely to doctor<br>• Predictive genomic testing<br>• Precision medicine |
| **Condition management** | • Outbound call centre-based case management<br>• Untimely with disjointed data usage | • Real-time monitoring, linked to other personal data<br>• Big data analytics to deliver personal insights |
| **Care delivery** | • Traditional sickness and repair healthcare in:<br>  – Hospitals<br>  – Physician clinics<br>  – Workplace | • Accountable care organizations (ACOs)<br>• Convenient care settings<br>• Mobile phone-based delivery platforms<br>• Centres of Excellence for specific diseases |
| **Therapeutics** | • Classic pharma, consumer health and medical device business models | • Advanced packaging and drug delivery to monitor adherence and simplify medications<br>• Use of big data and real-world evidence<br>• New product categories |

☐ Information-based healthcare.
All emerging models are underpinned by rapid advances in technological infrastructure through collection, coordination, and analysis of vast amounts of data that can provide value-creating insights

Source: Oliver Wyman analysis

Given the increasing pressure from Amazon, retailers are also looking at new growth avenues. They can make good use of the fact that consumers are increasingly open to receiving health guidance from non-traditional sources. For example, an Oliver Wyman survey of UK shoppers found that 60 percent believe it is their supermarket's responsibility to help them be healthier. A separate US-focused survey found that almost 80 percent of consumers who had visited a health or wellness clinic within a grocery store, discount retail store, or drug store within the past two years said the experience was about the same or better than a traditional doctor's office (see "The New Front Door to Healthcare is Here," Oliver Wyman, 2016).

In fact, the US now has twice the number of retail clinics it had only three years ago, with key players like Walmart and Target generating substantial new revenue streams out of it and strengthening their value proposition in the process. In another significant move by a large retailer, the US pharmacy chain CVS Health is looking to acquire Aetna, which sells healthcare insurance and related services (such as dental, long-term care, and disability plans). The merger will enable CVS Health to provide a broad range of services at its nationwide network of drug stores and clinics, reducing its reliance on the retail sales that face such tough competition. And most recently, the proposed Albertsons/Rite Aid merger is yet another example of how retailers see tremendous potential in growing their brands and businesses – not by growing in physical size, but in their ability to grow their impact and thus enable greater change.

# THE KEY SUCCESS FACTOR: CREATING HEALTH ECOSYSTEMS

In the new health market, consumers want to move seamlessly between daily living and their interactions with the healthcare system. Consumers expect a singular experience, without borders and boundaries separating wellness efforts from shopping, social support, or a visit to a healthcare provider. A comprehensive health ecosystem needs to address these multiple consumer touch points, to effectively surround particular life stages and situations with the right level of consumer support and engagement.

Because CPGs and retailers have existing consumer touch points, trust, and engagement skills, they are well positioned to create such an ecosystem. The playing field is very large and there are many ways in which companies can use the new space to meet consumers' needs. Exhibit 3 illustrates how CPGs can approach the strategic thinking behind these opportunities.

One such approach would be a pregnancy and early-life management offering. Danone has taken steps in this direction, notably through its Nutricia website and mobile app targeted at pregnant women and young mothers; it is already considered a leading player in this field. To build an end-to-end ecosystem for this area of healthcare, retailers or CPGs need to make certain kinds of tools easily available to expectant and young mothers.

**Exhibit 3: Mapping of direct-to-consumer healthcare opportunities**
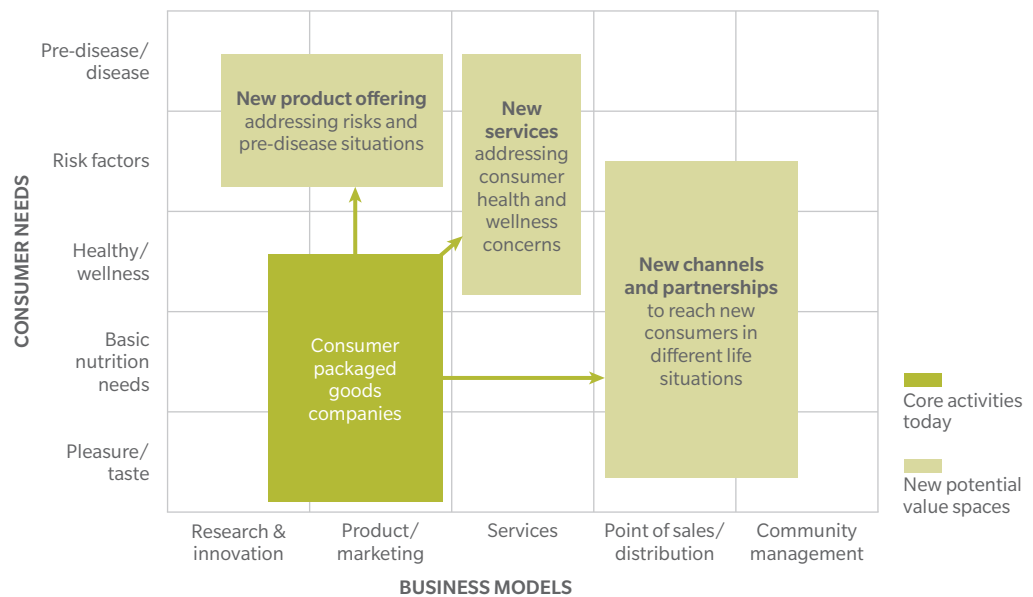


Source: Oliver Wyman analysis

**These could include offerings that:**

- Monitor the mother's own and baby's health data.
- Track dietary information.
- Order diapers, baby wipes, or formula immediately.
- Track vitamin consumption.
- Plan doctor appointments and receive automatic reminders.
- Seek and receive age-specific information through a live Q&A forum with experts.
- Track and store photos and development milestones via a personal diary interface.
- Participate in social communities, such as other mothers at similar stages.

For this and other examples, companies cannot have all the necessary expertise and capabilities in-house; retailers and CPGs need to look for external partners with which to build a health ecosystem. Research partnerships with universities and biotech companies can supplement internal research and development efforts. Working with start-ups that have developed new medical devices and solutions is another way to build innovative tailored offerings. Last but not least, partnering with digital and tech companies can help accelerate the development of new leading health solutions. In a similar initiative, Samsung and Nestlé are combining their "internet of things" and nutrition science capabilities to provide new consumer insights. The first pilot schemes started in 2017 and are focused on understanding the human body's "voice" to provide personalized recommendations for nutrition, lifestyle, and fitness. The winners will be those companies that are able to broaden their capabilities so they can expand their presence across the value chain – and multiply consumer touch points in the process.

# WHAT COMES NEXT?

The consumer healthcare opportunity is immense with plenty of room for CPGs and retailers to grasp key aspects of it.

Most players are still in the scoping stage and identifying possible entry points.To explore and get ready for new approaches, CPGs and retailers should focus on understanding consumer hassles and thinking beyond their normal interactions to come up with several potentially disruptive ideas. They can then progressively shorten the list through more thorough investigation and consumer focus groups before finally evaluating and acting on the business viability of these ideas within the framework of the overall company strategy.

Are retailers and CPGs willing to take the leap and step outside their comfort zone to become healthcare's next disruptors?

# CHINA BLENDS ONLINE AND OFFLINE RETAIL WORLDS

## ALLIANCES BETWEEN DIGITAL AND TRADITIONAL STORES AIM TO EXPAND ONLINE COMMERCE TO NEW AREAS

E-commerce has grown faster in China than in any other large market in the world. The growing middle class is boosting retail demand, but traditional stores are underdeveloped. To fill the gap, online retailers have made big investments in delivery infrastructure and e-payments, which are being taken up by a digitally advanced population. As a result, Chinese online retail sales shot up from 800 billion renminbi in 2011 to 5.2 trillion in 2016.

Now, Chinese retailers are trying out ways to break down some of the remaining barriers to digital shopping. Chinese consumers have been reluctant to buy certain items – in particular, fresh food – before they have seen them with their own eyes. So e-commerce players are setting up stores as showrooms and entertainment centers. Shoppers can check out the wares while researching them online, and then order via smartphone for quick home delivery. In sparsely populated rural areas, e-tailers have struggled to turn a profit on home delivery, but they are now opening efficient networks of convenience stores to solve the "last mile" problem.

**Exhibit 1: Comparison of the share of e-commerce retail of total retail**
Development of China's e-commerce retail has significantly outpaced other markets

PERCENTAGE OF E-COMMERCE RETAIL SALES OF TOTAL RETAIL SALES, 2011–2019E
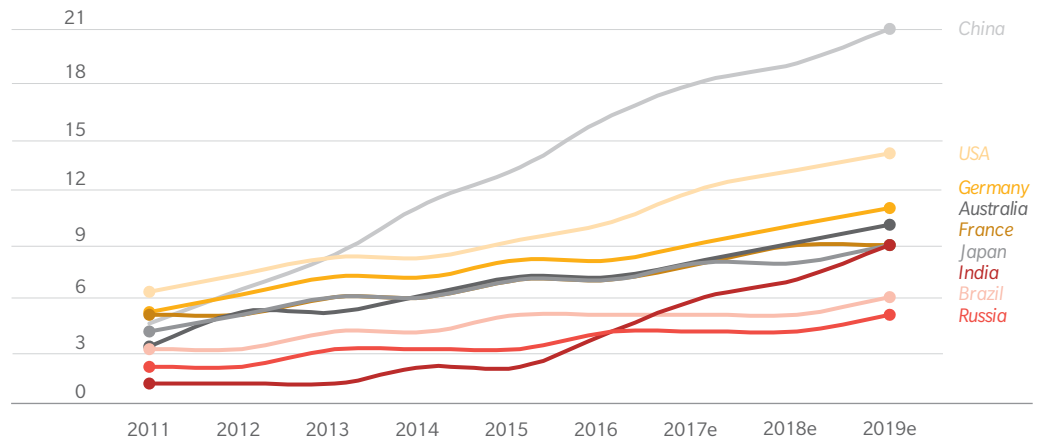


Source: National Bureau of Statistics of China, iResearch, Euromonitor, Oliver Wyman modelling, Oliver Wyman analysis

A range of new models is emerging as a result, and China even has a term for this new trend: O2O, Online to Offline. Physical retailers need the tools of e-commerce, and are obtaining them by partnering with an e-commerce player. E-commerce players – of which two, Alibaba and JD, dominate – are realizing the limits of a purely online model in some segments, and are establishing a physical presence close to consumers. This will also let them fight their way into traditional retail.

# SHOWING OFF THE PRODUCTS

One prominent example of the new model was the pop-up showrooms set up for China's most recent Singles' Day – an annual shopping festival that has become the world's biggest single shopping day with nearly $50 billion in sales. Young, single Chinese looking to buy themselves presents on November 11 in 2017 could visit one of 60 popup showrooms in malls round the country. There, they could browse furnishings in a model house divided into kitchen, study, bedroom, bathroom, and living room. Or they could try on 10 different outfits in two minutes through virtual fitting using augmented reality. They could look up information on the products on their smartphones via QR codes – and then click to buy them for home delivery.

Alibaba plans to expand the model, and has invested over $9 billion in brick-and-mortar stores since 2015, most recently taking a 36-percent stake in China's top hypermarket operator, Sun Art Retail Group. Counting all its retailer investments, Alibaba is now the largest offline

retailer in China as well as the largest online. Rival JD.com is also bridging online and offline by opening over 5,000 online-to-offline home appliance stores through franchising. Consumers can check sample machines and place an order on JD.com by scanning a dedicated QR code in store. JD will then arrange home delivery and provide after-sales service.

# CRACKING FRESH

Showrooming might also help crack one of the hardest areas for online retail: fresh food. Customers like to see, feel, and smell it before buying, which is not possible online. Another challenge is delivery speed. An average Chinese household makes five shopping trips a week to buy fresh products to cook and eat that day. But online shopping sites for electronics and apparel normally deliver food too late.

Alibaba's Hema supermarkets get around these problems. They have the appearance of regular supermarkets with plenty of fresh food on display. But they operate quite differently. Aimed at young, digitally savvy consumers, they let customers read product information via barcodes and order online for home delivery inside 30 minutes. Alibaba is said to be planning a major rollout of these Hema stores, which could change the way inhabitants of larger cities buy fresh food.

JD.com has launched its own variation on the online-to-offline theme. Local grocers can sign up to a network it runs – JD New Dada – so that consumers can order fresh products from them via an app. One of these partners is supermarket chain Yonghui, which is known for high-quality fresh products and is now getting several hundred additional orders a day via the app. Other partnerships include one between JD and Walmart to deliver all products available in Walmart stores through JD New Dada, and to install JD kiosks for order and delivery in Walmart stores.

The e-commerce giants are also moving in on the convenience store sector. JD.com has announced ambitious plans to open 1 million by 2021, primarily in smaller cities using a franchise model. It will supply the stores through the JD.com wholesale platform, which already serves hundreds of thousands of independent shops. The arrangement will increase JD.com's scale, making its logistics network more efficient and helping it to negotiate favorable terms with suppliers. Alibaba, too, has launched its own convenience stores and wholesale platform.

These developments are all reactions to local circumstances: China's lack of great incumbent supermarkets, big online population, and densely populated cities. But many of the challenges are familiar everywhere: Online retailers worldwide are struggling to increase their share of the food market and provide as much fun as a store can. If Chinese retailers manage to construct a compelling model combining the best of online and offline experiences, retailers in the rest of the world might be interested to see how they do it.

# UNITED STATES CONSUMERS RETHINK GROCERY

## DISCOUNTER LIDL RECENTLY OPENED ITS FIRST STORES IN THE UNITED STATES, AND EARLY CUSTOMERS ARE IMPRESSED

Lidl, one of the world's largest grocery chains, entered the US grocery market this summer, raising two major questions: Will American consumers give this new hard discounter a chance? And, if so, how much of their grocery spending will shift to Lidl?

Lidl joins Aldi in the US, and collectively have successfully entered 20+ countries from Austria to Australia. Given their success in exporting their format, the question might be better posed as, "what makes the US consumer so different that we should not expect Lidl to have a significant impact on the US grocery market?"

One key difference in the US is the low-end, entry market positioning of private label and how this historical view might decrease Lidl's chances for success. Another difference is the dominating strength of national brands and their predilection for winning the consumer through advertising, coupons, discounts and deals.

Most US supermarkets have an entry price point private label line, offering consumers a lower-cost, lower-quality choice against national brands – but few pack their store with a premium or a national brand equivalent private label line. The labeling (and contents) of entry price point private label has stepped up from its initial stark, black lettering on a white label, e.g., "Green Beans", however without the support of advertising, the signals from the packaging, taste, quality and price point reinforce the position of an inferior alternative.

With private label a somewhat unattractive second, national brands continue to dominate store aisles by creating demand through advertising to consumers and providing trade funds to grocers. This push/pull model has sensitized the American consumer to continuously look for deals on national brands, while simultaneously making it attractive for grocers to stock these products. It is interesting to note that discounts are much more common in US retail than in other parts of the world, for example, clothing retailers offer 30, 40 and 50% off on a regular basis.

It is against this backdrop of poor private label perception and a marketing machine surrounding national brands that we conducted a survey of grocery shoppers both before and after they had shopped at Lidl. Their answers will surprise US grocery executives, as their customers favor Lidl not only for its value and private label, but also for its fresh produce and assortment. Lidl's appeal is also economically broad, with income brackets matched well with those for incumbent grocers. These early findings, combined with Lidl's success in entering 20+ other countries, underscores Lidl as a serious threat to US incumbent food retailers.

# DISCOUNTERS WILL CAPITALIZE
# ON US GROCERY TRENDS

Over the past decade, consumers have been changing the way they shop for food, dividing their spending across a variety of stores and formats. Their behavior is fueling a widening range of choices: supermarkets, hypermarkets, clubs, convenience stores, dollar stores, meal kits, online services, and restaurants offering the option to "take a meal home". Food-at-home has become everyone's business.

Amidst all this choice, Lidl has entered the United States with bold plans to build an estate of more than 1,000 stores in less than five years. Aldi, its international discount rival, responded with a $5 billion plan to modernize and build out its current US estate of 1,500 stores, aiming for over 2,500 stores in the same period. Are these wise moves? Aren't American consumers already spoiled for choice? And what can Lidl offer to attract consumers to its dominantly private-label offering? Isn't Tesco's Fresh & Easy foiled entry a word to the wise?

We asked consumers what they thought, beginning with their impressions of Lidl the week before the first US stores opened: Would you shop at Lidl, and why? Eight weeks later, after shoppers had the opportunity to trial the stores and the products, we asked again, covering a wide range of topics.

In the multi-year run-up to Lidl's entry, the conventional US grocery industry wisdom has been that Lidl, like Aldi, is a one-hit wonder: great on value but not much else. In our analysis of customer attitudes across Virginia, North Carolina, and South Carolina, we learned that Lidl is generally perceived as stronger on value, beating every competitor in these markets on this dimension. However, Lidl's threat to incumbent grocers is much broader than value alone – the company beat most domestic competitors on fresh and private-label product perception, as well as on the shopping experience. While not dominant in assortment, Lidl had a better perception on assortments than some incumbents. In its first 3 months in the market, Lidl certainly seems headed in the right direction.

This initial success sounds an industry alarm. Winning on factors beyond value combined with an aggressive rollout strategy, means that Lidl's entry is likely to pull several billion dollars of grocery spending away from incumbents. The company has a proven track record in over 20 countries of understanding consumers, getting them to trial its stores, and – over time – turning them into loyal customers. We believe there is a clear and present danger, and offer the following observations with the aim of starting a conversation on how supermarket executives can retain their customers and thrive despite this new competitor.

# SHOPPING AT LIDL: THE CONSUMER VIEW

We asked more than 500 consumers in Virginia, North Carolina, and South Carolina about Lidl before it opened stores in the US. After two months of the shopping experience, we surveyed more than 300 actual Lidl shoppers, as well as almost 2,000 other shoppers from the same states.

### In direct comparison with incumbent grocers, Lidl wins on unexpected dimensions

Lidl clearly wins on value, but consumers also rank the company no worse on assortment than such national supermarket chains as Kroger and Walmart. This is quite surprising given that these players have more than twenty times as many products as Lidl. Moreover, even upscale local grocers that are well-known for excellent service, fresh products, and private brands scored only on par with Lidl on those dimensions.

### Lidl attracts shoppers from all incumbent grocers

Consumers that shop at Lidl include the loyal customers of a broad range of grocers. Lidl not only attracts other discounters' clientele, but also loyal customers of national chains such as Walmart and Kroger, and regional grocers such as Food Lion and Publix. Only 9 percent of the first-time Lidl shoppers considered discounter Aldi as their main grocer.

### Once a Lidl store opens nearby, customers will almost definitely shop there. However, gaining awareness seems to be a challenge

Among almost 2,000 shoppers who had not tried Lidl, only 8 percent were not interested in doing so. The other 92 percent did not shop there simply because Lidl had not yet opened a store nearby, they were not aware of Lidl, or they just hadn't had the time so far.

### Households of all income levels are open to shopping at Lidl

Contrary to commonly held industry wisdom, households at all ends of the income spectrum appear prepared to shop at Lidl. In fact, 43 percent of first time Lidl shoppers had an annual income over $75,000, which is very similar to the profile of an average shopper elsewhere.

### Lidl shoppers say they will continue to shop at Lidl

Before Lidl's store openings, 39 percent of consumers said they would shop at Lidl once a week or more in the future even though they had never stepped into a Lidl store before. After actually trying Lidl, this number increased to 56 percent. The key question is how this number will evolve in the next months, as the novelty wears off.

### Lidl surpassed the expectations of most customers, though 27 percent were disappointed
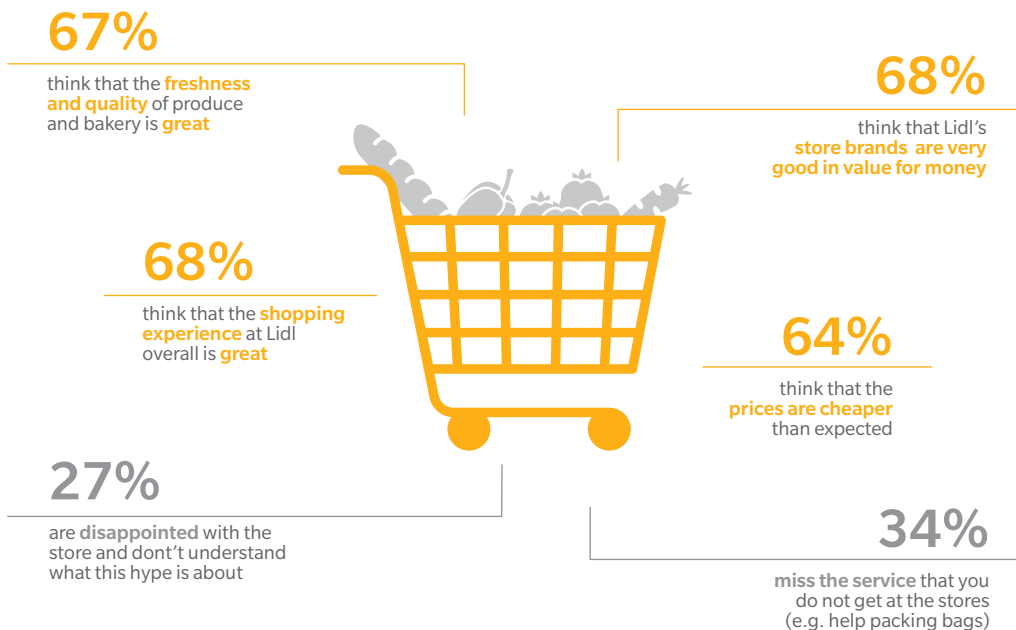
Consumers rated their overall shopping experience at Lidl positively – something that should bother incumbents. More than two-thirds of shoppers thought Lidl offered great freshness and quality in the perishable assortment and that it surpassed their expectations for the shopping experience and prices. However, 27 percent of first-time shoppers were disappointed with the store and not likely to become Lidl fans in the short term.

# IMPLICATIONS OF LIDL'S ENTRY INTO THE US MARKET ON INCUMBENT GROCERS

Grocery retailing is a zero-sum game, meaning every dollar spent at Lidl will go missing from incumbent grocers' cash registers. Lidl and Aldi, given their expansion plans could be operating close to 4,000 stores across the US in less than five years, with revenues circa $30 billion. That size shift in consumer spending will put significant stress on incumbent grocery retailers, forcing weaker operators into defensive positions. We recommend incumbent retailers respond by re-defining their strategies to account for this market shift – and to do so fast.

Independent of the chosen strategies, we believe retailers will first need to generate cash, as this will be necessary both to fund investments in closing the price gap and to make the estate improvements that will define their differentiation. We know that many retailers have been cutting costs, squeezing out a little more each year in budgets, salami-slicing labor staff levels, and challenging expense budgets. Unfortunately, these incremental cost take-outs will not be enough.

**Exhibit 1: How do early Lidl shoppers rate their shopping experience?**
Lidl surpassed the expectations of most customers

**67%**
think that the **freshness and quality** of produce and bakery is **great**

**68%**
think that Lidl's **store brands are very good in value for money**

**68%**
think that the **shopping experience** at Lidl overall is **great**

**64%**
think that the **prices are cheaper** than expected

**27%**
are **disappointed** with the store and dont't understand what this hype is about

**34%**
**miss the service** that you do not get at the stores (e.g. help packing bags)
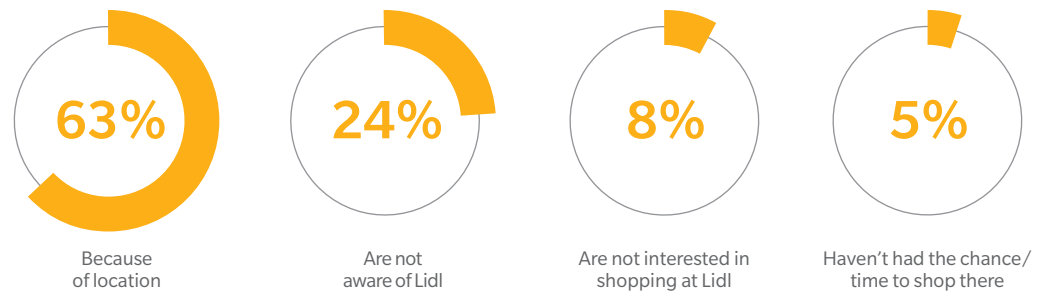
Source: Oliver Wyman analysis

# CEO AGENDA FOR THE 24 MONTHS BEFORE LIDL ENTERS THEIR MARKET

Lidl has been in the US market for only a few months but already industry reports are declaring they are in trouble, citing management changes and loss of shoppers. We believe these items are far less relevant in predicting Lidl's long-term success than the consumer insights we have captured. Lidl has demonstrated in country after country they play the long game; tuning their offer, driving customer trial, and connecting with them to achieve repeat purchase. We believe Lidl are a serious threat and warrant CEO attention and action.

**Exhibit 2: Why do consumers not shop at Lidl?**
Customers trialed Lidl's stores when they were aware of them

| | | | |
|---|---|---|---|
| **63%** | **24%** | **8%** | **5%** |
| Because of location | Are not aware of Lidl | Are not interested in shopping at Lidl | Haven't had the chance/ time to shop there |

Source: Oliver Wyman analysis

**Fund investments for growth by profoundly cutting costs:**
- Radically simplify the business – operate more leanly in stores and in head office.
- Change the nature of relationships with suppliers.
- Consider automation and artificial intelligence.
- Manage the asset base more aggressively.

**Invest in value and offer differentiation:**
- Invest in prices to be within your customers' willingness to pay a premium.
- Invest in better customer engagement and services that support your new positioning.
- Invest in a strong private brand – adapt to major customer trends.
- Invest in strengthening the overall assortment – localize and offer true choice.

Lidl's entry into the US is a clear threat, in our view, to incumbent grocery retailers. We believe early shifts in strategy funded by step changes in cost reduction can position grocery retailers to retain their customers and find ways to thrive, even as Lidl and Aldi realize their plans to grow aggressively in the US.

# FIRST-TIME LIDL SHOPPERS LOOK LIKE LOYAL SUPERMARKET SHOPPERS

## HOW LIKELY ARE THEY TO BECOME REPEAT LIDL CUSTOMERS?
56% OF ALL LIDL SHOPPERS SAY THEY WILL SHOP THERE MORE FREQUENTLY IN THE FUTURE (ONCE A WEEK OR MORE OFTEN)

**39%** **Before** Lidl opened

**56%** **After** Lidl opened

## WHAT IS THEIR INCOME PROFILE?
INCOME DISTRIBUTION OF LIDL SHOPPERS VS. OTHERS, IN PERCENT

**Lidl Shoppers**
9
34
42
15

**Discounter**
5
29
52
14

**Average Shopper**
11
31
48
10

>150 K
75–150 K
25–75 K
<25 K

## HOW BIG ARE THEIR BASKETS?
SHARE OF BASKETS >20 USD

**58%** Lidl

**70%** Discounter

**85%** National Grocer

## WHICH IS THEIR CURRENT, PREFERRED GROCER?
PERCENT

| Wal-Mart | Food Lion | Harris Teeter | Aldi | Kroger | Publix | Costco | Target | Lowes | Bi-Lo | Other Grocers |
|---|---|---|---|---|---|---|---|---|---|---|
| 25.2 | 17.2 | 11.2 | 9.3 | 7.6 | 4.9 | 2.9 | 2.7 | 2.3 | 2.3 | 14.0 |
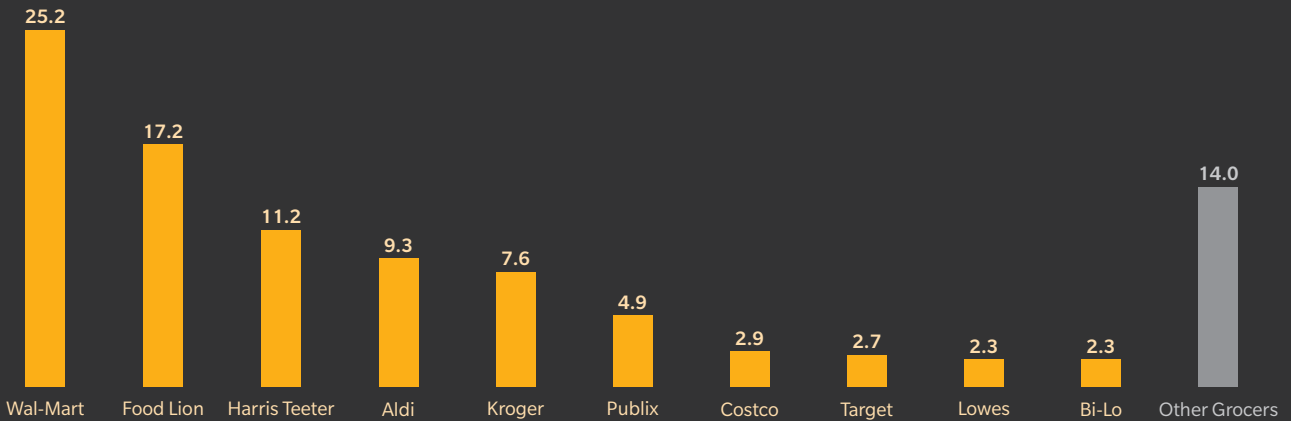
# BUILDING A $10 BILLION BEAUTY BRAND THROUGH BOUTIQUES

## WHY PHYSICAL RETAIL IS IMPORTANT IN AN ONLINE ERA

The beauty market may appear calm on the surface, but underneath there is plenty of turbulence. With sales growing an average of only 0.2 percent a year between 2011 and 2016, no player can rely on today's apparent state of stability. A deeper look reveals differences in performance across and within different markets.

The variation between regions has been considerable. Asia and North America delivered a growth rate of over 10 percent, while Europe and Latin America struggled. Different categories, too, have varied in their success. Color products have benefited from sustained customer appetite – in particular for BB (blemish base) and CC (color-correcting) creams and lip products – while mass fragrances and body care products are steadily losing revenue.

But the most noteworthy change has been in the retail channels. Traditionally, the prestige segment has been dominated by department stores, but it is now transitioning to a direct-to-consumer (D2C) model, as millennial consumers turn to e-commerce and to brands' flagship stores. New, agile, innovative brands have seen rapid expansion thanks to the D2C model, which gives them a variety of means – ranging from an online presence, to their own stores – to supplement or bypass department stores.

The traditional giants of the beauty industry – such as Estee Lauder, LVMH, and L'Oréal – have acquired some of the new brands. So far, their flagship brands have been left behind, despite some initial efforts to update their traditional distribution model in an attempt to defend

**Exhibit 1: Channel, regional, and category mix changes in the beauty market**

GROWTH RATE OVER THE 2011–2016 PERIOD, %



Source: Euromonitor, Oliver Wyman analysis

market share. If they too adopt the new paradigm of a close, direct relationship with customers, we think they have an exceptional growth opportunity. To do this effectively, they should overhaul their distribution strategies in ways that will make them more relevant to both their traditional customers and the new, more demanding, generation of consumers.

The D2C model can be the trigger for a step change in prestige beauty, and it presents a golden opportunity for global brands to grow into megabrands. Rather than playing it safe, they should fully embrace this transformation.

# THE EVOLUTION OF THE EXPERIENCE ECONOMY

The D2C model is evolving as a response to millennial consumers who are increasingly interested in personal experiences. Their expectations go beyond product features and they are looking to buy related services that cannot be delivered solely online. These new demands are giving rise to an experience economy, in which a brand's value lies in the emotions and sensory experiences it triggers, as well as the interpersonal relationships associated with it. E-commerce will continue to grow steadily, so every beauty player must craft and execute a sound e-commerce business model. But the key to significantly outperforming the market will be to combine an online presence with a well-executed own-brand store strategy.

A D2C model using physical stores enables brands to better communicate with and deliver products to their customers. In addition, it provides unprecedented access to customer data, which are essential for developing a successful customer-centric business. When a customer buys – or almost buys – something online, their journey to that purchase is a powerful source of information on their thought processes, habits, and preferences. By setting up a boutique, a brand gains access to the same kind of information, which it can use to improve its focus on customers' needs and desires.

This strategy has the potential to revive the cosmetics industry in the regions and categories where it is currently struggling. Today, beauty specialist sales are dominated by large, multi-brand chains such as Sephora and Ulta, and own-brand stores only represent a very small portion of sales. We believe that own-brand stores are an immense, untapped potential source of growth for beauty brands.

Sportswear makers have employed this strategy over the past two decades and benefited from the accompanying insights and lessons. Players such as Nike, Adidas, Lululemon, and Under Armour are all in the experience business: They have developed their own retail networks and learned how to leverage them to deliver high impact.

## EVOLUTION OF THE BEAUTY DISTRIBUTION MODELS

| | **1980s** DEPARTMENT STORES | > | **1990s** SPECIALTY STORES | > | **2000s** E-COMMERCE | > | **2010s** DIRECT-TO-CONSUMER |
|---|---|---|---|---|---|---|---|
| Players | Macy's, Harrods, Galeries Lafayette | | Sephora, Ulta | | Amazon | | MAC, NYX, La Clé de Peau |
| Economy | Product | | Services | | Convenience | | Experience |
| Demand | Features | | Benefits | | Ease | | Emotion |
| Activity | Produce | | Support | | Deliver | | Stage |
| Offer | Standardized | | Customized | | Pushed | | Personal |

## NIKE IN NUMBERS

### 1990

NIKE OPENS **FIRST** NIKETOWN IN PORTLAND

Initially conceived as a showroom to avoid cannibalizing sales through wholesalers – A brand promotion tool to stimulate buying at other retail outlets

### NOW

**1,045** NIKE STORES ACROSS THE GLOBE

Stores used to promote the brand and deliver a unique product/service experience – Products can be tested or even created by the customer

NIKE CAGR* 2009–2016:

**6%** WHOLESALE CHANNEL

**20%** DIRECT-TO-CONSUMER

NIKE REVENUES EVOLUTION BETWEEN 2009 AND 2016

**2009:** **$16.8 BN**

**2016:** **$30.5 BN**

* CAGR: annual compound growth rate
Source: Oliver Wyman analysis

Nike opened its first Niketown in Portland in 1990, initially seeing it as a showroom to increase product exposure. Since then, Nike has opened more than 1,000 stores worldwide, using them not just for institutional communication but, more importantly, to sell directly to its customers. Through these stores, Nike learned that products would sell better if they could be tested or even created by the customers themselves. The company's revenues grew from $16.8 billion in 2009 to $30.5 billion in 2016, mainly driven by D2C sales, which increased 20 percent a year over that period.

Nespresso and Apple have also grown by using own-brand stores to better understand client needs so they can fine-tune their products and services. Perhaps more importantly, these stores have also been valuable laboratories for enhancing customer experience and driving growth in non-direct distribution.

This kind of transformation requires agility. Sports goods have usually been sold through small, independent stores, which do not have the power to prevent the likes of Nike from setting up its own stores. But big cosmetics firms have traditionally had deals with powerful retailers such as department stores and hypermarkets, which they were reluctant to upset by creating independent boutiques. So newer, smaller beauty brands have a structural advantage, as they do not need to struggle with the tectonics of these distribution channels or the big expenses associated with traditional media and marketing. Because of their inertia, the giants of the sector have only reluctantly begun to develop new distribution channels.

# DOUBLE-DIGIT GROWTH IS POSSIBLE

Indie cosmetics brands have excelled through their expertise in experiential multichannel retailing. They combine boutiques and an online presence in an experience-based sales model that gives them an edge over rivals.

NYX, for example, deploys specialist make-up artists in many of its stores, all of which are equipped with beauty bars, tutorial centers, and "looks books," so that every shopper can become their own make-up artist. Online sales are rising, but NYX has kept the in-store experience at the heart of the brand. The strategy delivered 55-percent annual growth between 2011 and 2016. "Cosmetics are a very tactile product, which people want to feel and see before they purchase," says Tonie Shin, Vice President of Marketing at NYX. The company was bought by L'Oréal in 2014 but has so far retained its indie DNA and business model.

Another new way to connect with customers was pioneered by Rodan + Fields, a US luxury skincare brand. The company's "community commerce" model, as it is now called, uses social media to deliver word-of-mouth marketing, and sales commission is offered to people who

2011–2016 CAGR OF REVENUE, %
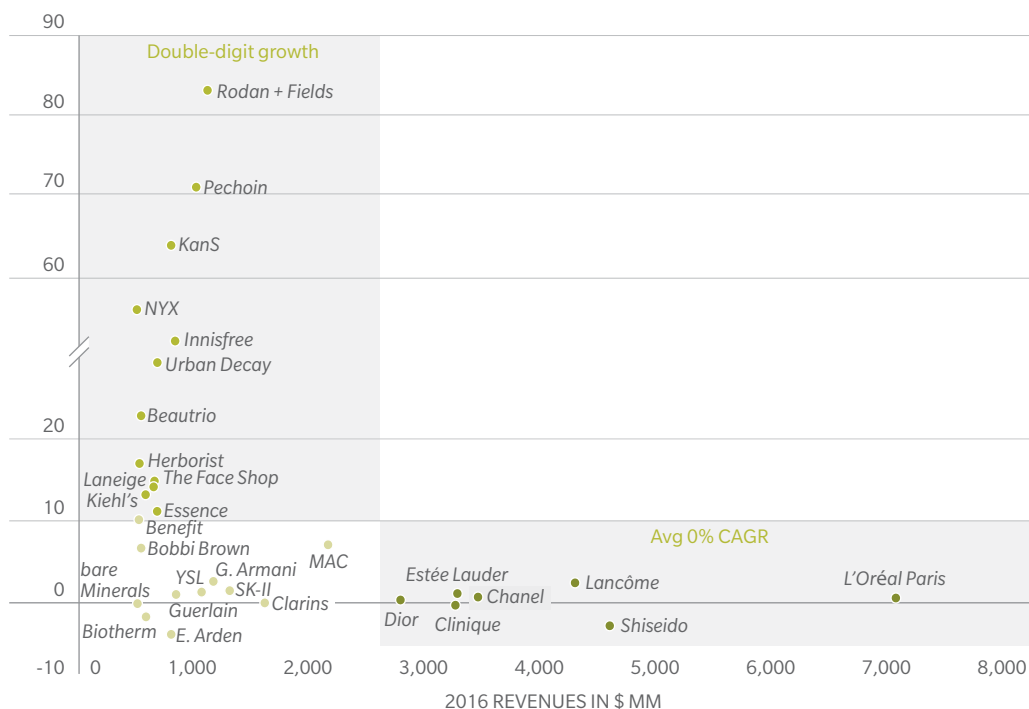


recommend the brand's products. This communication is supplemented by department store booths, where clients can have one-on-one consultations. Revenues, which come from beauty kits costing between $400 and $1,000, shot up from $50 million in 2011 to $1 billion in 2016.

A number of other indie brands achieved double-digit annual growth between 2011 and 2016 by combining e-commerce and brick-and-mortar stores in a genuinely direct-to-consumer approach. In contrast, established global brands had flat sales over this period and struggled to maintain market share. (See Exhibit 2.) To boost their brands and growth, they should rapidly invest in experiential marketing and craft more-integrated multichannel strategies.

One reason cosmetics brands have been slow to set up their own stores is the high cost. However, if the stores are rolled out with the right customer relationship management capabilities and salesforce, they are the best way to maintain control over customers as well as an opportunity to boost foot traffic and sales. Nike doubled its revenues – so there is no reason a beauty brand should not do the same, going beyond the generally accepted maximum scale of around $5 billion and expand to $10 billion.

# SIX GOLDEN PRINCIPLES FOR IMPLEMENTATION

A direct-to-consumer strategy can be a powerful growth driver for beauty brands. While online channels make a substantial contribution, they must be supplemented by own-brand stores because of the growing importance of the experiential economy. These stores should leverage direct marketing capabilities to increase the average basket, as well as operations that optimize execution, limit operating costs, and get the best return on investment.

Exhibit 3: There are six golden principles for beauty brands to develop their own retail networks

CUSTOMER VALUE PROPOSITION

**Memorable experience**

Experience at the heart of the customer journey; sales almost as a collateral impact

**Unrivalled value**

An offer that is differentiated between channels and that brings best value for money

**Bricks and clicks**

Seamless integration with online business to mutually reinforce D2C model

**Customer relationship management (CRM) expertise**

In-store associates as pivot in customer relationship based on intimate knowledge of client data

STORE OPERATIONS

**Effectiveness and efficiency**

Impact via strong visual identity and profitability thanks to lean management of investment and operating costs

**Innovation lab**

Easy testing of new products in real-life conditions with fewer financial risks

DIRECT MARKETING CAPABILITIES

Source: Oliver Wyman analysis

## PROVIDE A MEMORABLE EXPERIENCE

Personalized services help to give customers an emotional experience, increase brand awareness – and, ultimately, drive sales. Sales points are being turned into showrooms, where customers experience different products in stages. First they have a skin diagnosis, then go to the beauty studio. After that they visit the nail bar, followed by flash skin care. Personalized experiences raise customer satisfaction and increase traffic. For example, when Dior opened its first make-up boutique in New York in November 2016, there were six make-up counters and a skin diagnosis counter. There was also a mix-and-match video table, where customers could experiment with different colors of lipstick and nail polish on a virtual model.

## DELIVER UNRIVALLED VALUE

Own-brand stores will coexist with department stores, online channels, and specialist retailers, so customers will need a compelling reason to choose any one of these. This could be a product assortment broad enough to make them the go-to place to access an entire range or to find limited editions and avant-première products. The make-up boutique opened by L'Oréal Paris in 2016, for example, showcases more than 600 products, of which 150 are exclusive, and displays one limited collection per month. Customers can also preview new products and attend events.

However, the integrity and coherence of pricing need to be carefully managed: If boutique prices are too low, they might undermine other channels; if they are too high, the brand might lose customers' trust. In an age of digital transparency, customers must be confident that a brand's own boutique will have the best prices for all available products. One way to control prices is through a coherent, cross-channel strategy. Product assortment also needs careful management in order to maintain a smooth relationship with wholesalers and avoid cannibalization. This can be done by carefully tailoring each channel's product assortment according to criteria such as size and color. Then, unique products and pricing can be sold through different channels without cannibalization.

## KNOW YOUR CUSTOMERS

Maximizing revenues requires better engagement with customers, so that they will make purchases more frequently and increase the average size of their baskets. To build an intimate knowledge of customers, brands will have to invest in customer relationship management, by developing tools, recruiting talent, and making use of external resources. This will help them to better personalize their direct marketing and build stores that respond more to customers.

Brands will have to build the right data management systems and transform their workforces so that staff can work with the new systems. Traditionally, information about consumers was collected through external studies carried out by a specialized market research department. Now, big-data and analytics skills will leverage new data on customer purchases and from research. These are valuable resources, which are now directly accessible through the new channels.

Sales associates will play a major role in embedding customer knowledge, so their responsibilities will go beyond merely selling products. They must represent the history and values of the brand, be true experts in their product category, and engage with customers. The era of the generalist beauty advisor seems to be over. They will be replaced by specialists, such as perfumers for fragrances and make-up artists for cosmetics. Building the right capabilities is the trickiest and most important challenge for beauty retailers, and it raises a number of questions: How do we increase the skillset of existing beauty advisors? What should be the mix between internal and external specialists? How do we turn experts – make-up artists and therapists, for example – into effective sales associates? The answers to these questions will vary between brands, and they will depend on current capabilities and the degree to which existing sales associates' skills can be improved.

## SET UP AN INNOVATION LAB

Dedicated boutiques can also act as labs to help rapidly create, test, and launch new products, by reducing the friction that occurs between development and launch. The tests can be carried out in real-life conditions with little risk or volume, saving time and energy that would otherwise be needed to coordinate with third-party retailers. Test results can be used to persuade third-party retailers to distribute new products in the second phase of a launch. They can also contribute to demand forecasts.

These innovations will increase traffic to boutiques and better satisfy loyal customers. Indeed, presenting innovations to customers before wholesalers is a very effective way to trigger repeat visits and purchases.

## BE EFFECTIVE, BE EFFICIENT

In much of Asia, beauty brands have acted as their own retailers for 30 years or more, helped by the relatively low price of real estate in prime locations. In the United States and Europe, good locations are rare and expensive, making it hard to set up a profitable boutique. It is therefore important to choose locations carefully and optimize the use of space. Financial considerations aside, smaller boutiques can provide a more intimate experience than department stores, which are often impersonal and disorienting. For example, Rituals owns 520 stores of between 60 m² and 100 m² in size that emulate aspects of a luxury spa to provide a soothing, relaxing shopping experience.

The décor and visual atmosphere of the point of sale also contribute to a memorable experience for customers. With just one glance, customers should be able to perceive and understand the brand's values. Most of the outperforming challenger brands focus on one product category at each point of sale – make-up, skincare, or fragrance, for instance. This helps them present a clear picture of what they represent. Multicategory brands face the challenge of balancing the store's design and total area for different product types, keeping features such as fragrance testing and make-up trials separate in a small space.

When investing in new boutiques, brands should aim for high quality at the best possible price, for example by anticipating areas about to become trendy and signing leases before prices rise. In established retail areas where brands have to be located, brands can seek to optimize construction costs – though this is often difficult, given the requirements for prestige brands, such as upmarket, expensive materials. We have seen some brands innovate in their interior decoration by using local materials. Doing this can strengthen a brand's image, while also helping the brand adapt to regional specificities and deliver value for money.

## USE BOTH BRICKS AND CLICKS

Own-brand networks need to be completely integrated with online retail operations. While the physical network is the best way to deliver a differentiated experience and increase a brand's share of customers' spending, online features have a key role to play in triggering repurchases. However, many beauty players separate their online and brick-and-mortar customer relationship management (CRM), preventing both from fully leveraging all the available information on customers. At some point, boutiques will evolve to become more like showrooms than points of sale. Customers should then have a seamless experience with the brand across every channel.

# ACT – BECAUSE OTHERS WILL

Own-brand retail networks have the potential to turn the beauty industry upside down. If global beauty brands do not act swiftly, they might find themselves overtaken by the trend, which will be more than a passing fad.

However, if they seize the direct-to-consumer model as an opportunity, it could help them to form relationships with customers, regain double-digit growth, and turn into megabrands. To do this, they must invest in CRM capabilities, increase their direct marketing skills, and train their boutique staff. They will then be able to open inspiring own-brand sales points and craft unforgettable customer experiences, while still controlling their costs.

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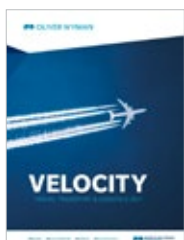
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www.oliverwyman.com

## CONTACTS

JAMES BACOS

Global Retail Practice Leader
james.bacos@oliverwyman.com
+49 89 939 49 441

WAI-CHAN CHAN

Global Consumer Goods Practice Leader
wai-chan.chan@oliverwyman.com
+852 2201 1700

NICK HARRISON

Global Retail Practice Co-Leader
nick.harrison@oliverwyman.com
+44 20 7852 7773

SIRKO SIEMSSEN

Global Retail Practice Co-Leader
sirko.siemssen@oliverwyman.com
+49 89 939 49 574

RICHARD McKENZIE

Retail & Consumer Goods Practice Lead – Asia
richard.mckenzie@oliverwyman.com
+852 2201 1700

FRANCOIS AUBRY

Retail & Consumer Goods Practice Lead – France
francois.aubry@oliverwyman.com
+33 1 4502 3388

RAINER MUENCH

Retail & Consumer Goods Practice Lead – Germany
rainer.muench@oliverwyman.com
+49 160 621 8210

COEN DE VUIJST

Retail & Consumer Goods Practice Lead – The Netherlands
coen.devuijst@oliverwyman.com
+31 20 541 9790

JEREMY SPORN

Retail & Consumer Goods Practice Lead – North America
jeremy.sporn@oliverwyman.com
+1 646 249 0517

MARIA MIRALLES

Retail & Consumer Goods Practice Lead – Iberia
maria.miralles@oliverwyman.com
+34 615 036 406

NORDAL CAVADINI

Retail & Consumer Goods Practice Lead – Switzerland
nordal.cavadini@oliverwyman.com
+41 44 553 37 64

ANDREW GLOVER

Retail & Consumer Goods Practice Lead – UK
andrew.glover@oliverwyman.com
+44 20 7852 7770

**OLIVER WYMAN**