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Perspectives on **retail and consumer goods**



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

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Foreword

Welcome to McKinsey's new consumer journal. Set up at the intersection of cutting-edge knowledge and practical business relevance, *Perspectives on retail and consumer goods* will help its readers turn the evolving issues of today's dynamic consumer industry into opportunities.

Twice annually, our practitioners and experts will take you behind the scenes of McKinsey's work in retail and consumer packaged goods. Drawing on our own research and our clients' perspectives, we will explore hot topics including—but not limited to—big data, multichannel retail, and emerging markets.

We hope you find this publication useful, thought provoking, and enjoyable. We are offering you our *Perspectives*, but we would like yours as well. Tell us what you think by e-mailing us at Consumer_Perspectives@McKinsey.com.

Sincerely,



Klaus Behrenbeck
Director, Cologne



Jorgen Rugholm
Director, Copenhagen



Beyond the hype: Capturing value from big data and advanced analytics

Consumer-facing companies must be able to gather and manage the right data, turn it into insights, and translate those insights into effective frontline action.

**Peter Breuer,
Lorenzo Forina, and
Jessica Moulton**

Retailers and consumer-packaged-goods (CPG) companies have long had access to vast amounts of transaction data: every day, companies capture information about every SKU sold to every customer at every store. In addition, companies regularly use sophisticated market-research techniques to answer a variety of questions: what products should we develop and sell? How much is the customer willing to pay? Which products should we discount and when? Which marketing vehicles will allow us to reach the most customers?

With reams of data and market research already at their fingertips, some consumer companies are understandably skeptical about the much-hyped promise of social-media information and other

large data sets now known as big data. Others see the potential but are cautious about making large IT investments, especially as they recall their experiences with customer-relationship-management systems that proved difficult to integrate into their business processes. Can big data and advanced analytics truly deliver more useful insights than existing tools? Will the return on investment from large-scale data warehousing and IT systems make a meaningful difference to the bottom line?

Our experience working with several large consumer-facing companies indicates that the answer to both questions is yes. We believe big data and advanced analytics are among the most



Bee

important battlefields for retail and CPG companies today. Benefiting from big data and analytics, however, isn't a given; companies must invest in the right set of capabilities and keep certain success factors in mind. In this article, we discuss the potential of big data and advanced analytics for the retail and CPG industries, and what it takes to turn this potential into actual value.

Immense possibilities

Big data makes it possible for companies to better understand customers' shopping behavior at each stage of the "consumer decision journey."

By analyzing online browsing and searching histories, for example, companies can learn the alternatives customers look at when considering buying a product, the important factors in their final purchasing decision, and how they put together their shopping baskets—information that can help companies identify valuable up-selling and cross-selling opportunities. Companies can also monitor how customers talk about a product on social media, including why they purchased it, which features they like and dislike, and what would prompt them to purchase it again. Companies can use these analyses to create more accurate "customer decision trees"—tools to help explain which products in an assortment are substitutable and which are complementary—and thus refine their offerings in both offline and online stores. Furthermore, technology now makes it easier to track customers' responses to media campaigns and promotions, giving companies insights into how to better target their media spend and create more profitable promotions.

Such data and analyses can help companies make better, faster decisions in their day-to-day business—including decisions about product

innovation, assortment, pricing, promotions, and retailer-supplier negotiations. Recent research by McKinsey and the Massachusetts Institute of Technology shows that companies that inject big data and analytics into their operations outperform their peers by 5 percent in productivity and 6 percent in profitability.¹ Our experience suggests that for retail and CPG companies, the upside is at least as great, if not greater.

Tesco, for one, attributes its success in part to insights generated through big data and advanced analytics. The European grocery retailer introduced a loyalty card in the late 1990s, using it as a vehicle for the systematic collection and analysis of shopper data. The company has since mined online and social-media information as well. It has developed a full set of advanced analytics—encompassing more than 20 analytical tools in its commercial functions—to support day-to-day decision making. Its insight-driven commercial strategy has contributed to sustained profitability: since 2000, Tesco has improved its profitability every year, more than tripling its profits between 2000 and 2012.

Making it happen: Three ingredients

What steps must companies take, then, to capture value from big data and advanced analytics? In our work, we have found that fully exploiting data and analytics requires three capabilities. First, companies must be able to choose the right data and manage multiple data sources. Second, they need the capability to turn the data into insights—that is, they must combine deep analytical talent with commercial judgment. Third and most critical, management must undertake a transformational-change program so that the insights actually yield better business decisions and translate into effective frontline action.

¹See Erik Brynjolfsson and Andrew McAfee, "Big data: The management revolution," *Harvard Business Review*, October 2012, and Dominic Barton and David Court, "Making advanced analytics work for you," *Harvard Business Review*, October 2012.

Companies must hire, develop, and retain skilled analysts who can distinguish relevant from irrelevant data.

Managing the data

As they embark on a data-and-analytics journey, many companies default to a “data forward” approach—that is, they gather whatever data they think might prove useful or simply use data they already have, in hopes that it will yield valuable insights. But big-data initiatives shouldn’t be fishing expeditions. We recommend instead a “decision back” approach, which begins with the company answering two related questions: which decisions do we want to improve? What data and analyses will help us improve those decisions? The answers to these questions will also be important during the later stages of the journey, when analytics experts are making choices about how to structure the data, where to push for 100 percent data accuracy, and whether to buy off-the-shelf software or invest in building proprietary solutions.

A retailer may, for instance, seek to make better decisions about its promotional spending. Here, the range of decisions can be quite broad: do we want to optimize the design (number of pages, number of products on each page) of our promotional leaflets and circulars? Do we want to reassess the distribution of our circulars—which newspapers they should be inserted into, which addresses they should be delivered to, and so on?

Do we want to rethink the product mix in our circulars? Each decision requires different data and analyses.

In identifying, sourcing, and managing data, retailers face a number of challenges:

The sheer number of transactions, as well as the time period required for analysis.

As mentioned earlier, the number of daily transactions and data points in retail is immense. To understand trends, companies must capture mountains of data over several years. They therefore must invest in robust databases that allow decision makers easy access to the data they need. Fortunately, data-storage capacity is becoming available at lower and lower costs; some companies are turning to software-as-a-service solutions to meet their evolving IT needs.

Data matching across repositories. A retailer’s loyalty-card database, for instance, doesn’t easily match up with its database containing product costs—which means implications on revenues will be straightforward to derive, but implications on gross margins will not. Leading companies are using new applications that can match different types of data from different databases by recognizing patterns.

Data “hygiene” and reliability. For instance, product information—package sizes, product descriptions, or even the category in which a product belongs—isn’t always up-to-date in retailers’ databases, in part because maintenance of data on a massive number of SKUs (as many as 300,000 for some large retailers) is a time-consuming and laborious effort.

Lack of history on certain data. Promotional uplift, for example, strongly depends on a product’s in-store position (a central promotional island versus an endcap versus a shelf). Some companies haven’t historically recorded products’ in-store positions, making interpretation and analysis of promotional uplift tricky. As a consequence, retailers sometimes develop a flawed or incomplete picture because they don’t have all the relevant data. Some companies are overcoming the lack of data through crowdsourcing. There are apps, for instance, through which a company can pay individuals to go to local stores to take photographs or gather data, which they can then submit to the company online.

Translating data into insights

Managing the data is just the first step. Companies need to next make sense of the flood of data. Sophisticated algorithms and analytical tools can help, but the tools alone don’t constitute a competitive advantage. Rather, it is the knowledge of how to leverage the tools that can vault a company above its competitors.

Companies must hire, develop, and retain skilled analysts who can distinguish relevant from irrelevant data, draw the right assumptions, and translate information into insights. But it’s important to strike the right

balance between analytical expertise and commercial sense. Retailers are of course commercially driven organizations. The key is to recruit top-notch analytical talent without subverting the company’s commercial DNA. Analytics should be an enabler for the commercial functions, not an end in itself. We have seen more than one retailer make the mistake of placing too much trust in a pricing-elasticity algorithm, for example, without questioning or debating its counterintuitive recommendations; these retailers increased prices, promptly lost market share, became disillusioned with the analytics, and abandoned the tools entirely.

Another common issue is the “black box” problem: big-data initiatives deliver unexpected results, and the owners or leaders of the initiative can’t explain the results in a way that stakeholders can understand. At other times, the answer is wrong, and the owners lose credibility when they try to defend their work. A way to avoid these pitfalls is to hire talent with analytical horsepower as well as acute commercial sense and business judgment. Individuals with both capabilities are in high demand and short supply; most companies will find that it’s easier—and just as effective—to instead build a team of people with both sets of skills.

Turning insights into effective frontline action

Gathering the right data and having the right skills, however, won’t yield impact unless the company can also turn data-driven insights into effective action on the front line. In most cases where companies have failed to generate value from big data, the reason has been insufficient attention to this third imperative.

Companies must make sure the new analyses and insights are embedded seamlessly into managers' and frontline employees' day-to-day decision processes. Software and tools should be intuitive and scalable. Processes should be defined in a way that managers and the front line can readily understand and adopt. For example, if a new workflow-management model crunches data on historical sales, planned promotions, and weather forecasts, then perhaps store managers could receive reports that estimate how many sales-floor employees and cashiers they will need every hour of the following week.

When designing new tools, companies should seek the least complex model that would improve performance. More sophisticated decision-support tools must be implemented very carefully; highly complex analytical algorithms (to calculate cross-elasticity or forecast demand, for instance) are at risk of not being understood and consequently not adopted. Leaders should prepare the organization for fundamental mind-set changes: people must be willing to reinterpret results, admit mistakes, and correct course if the data bring to light suboptimal decisions made in the past.

The front line should receive intensive training and coaching on the new model, and managers' incentives should be aligned to support the new way of working. One consumer-goods company, for instance, launched a program to boost the profitability of its promotional spending and introduced a new promotions-analysis tool for the sales force. Senior management even led the training for the program. But sales reps embraced neither the program nor the tool,

because company incentives and reporting protocols for sales managers tracked sales—not profits. After a series of discussions with sales managers, the company relaunched the program, introducing new profit-related incentives and reports.

Factors for success

Enabling an organization to benefit from big data and advanced analytics is a journey that can either yield dividends at each stage or generate frustration if investments don't pay off. We have found the following actions can help keep the journey on track:

Secure quick wins. Choose one or more areas where a focused investment in big data and analytics can prove the business case quickly. One European CPG company selected a discrete topic under the larger umbrella of generating growth in mature categories. In its highly competitive categories, it had come to rely on product innovation—which at times can be both expensive and risky—to spur growth. It used data on consumer attitudes and behaviors, as well as advanced analytics, to revolutionize its retailer-specific assortments and planograms: by understanding exactly which SKUs were selling well in which retail formats and determining which SKUs to swap in and out to best meet consumer preferences, it is now seeing 10 percent sales growth in a low-growth category. The early success of this initiative has generated a wave of activity on related topics, with strong business-unit pull for the new ways of thinking. Once the business case is established, the organization can get behind longer-term and larger-scale investments in data and analytics.

Require senior-executive sponsorship. Any big-data initiative needs an energetic senior sponsor who will dedicate at least 5 percent of his or her time to making the initiative a success. Senior sponsors must be involved right from the start and make sure the big-data experiment follows a decision-back structure. They then need to participate in validating results and use their authority to rewrite the relevant business processes.

Look to external examples. Most companies cannot rely on their organizations alone to find and clarify their big-data opportunities. This is an area where companies might think about taking an “open source” approach, tapping into external experts and networks for help on their biggest analytical challenges. Consumer companies can also take inspiration from big-data success stories, not just in the consumer sector but in analogous

industries; some groundbreaking initiatives in health care, government, and financial services, for instance, offer useful lessons for retail and consumer-goods players worldwide.



We see great potential for consumer-facing organizations that adopt big data and advanced analytics as a platform for growth. Companies can begin by agreeing on which business decisions they want to improve, defining their step-by-step journey and securing the right talent, and effecting the transformational change that will embed big data into their daily processes. Done right, such an initiative will have a payoff that will be more than worth the investment. ○





Making data-driven marketing decisions

The retail industry is just beginning to take advantage of big data. This article, adapted from the 2013 edition of *Retail Marketing and Branding*, describes a powerful data-analytics tool: marketing-mix modeling.

**Dennis Spillecke
and Andris Umblis**

As a retail executive, you want your ads to look good on the TV screen, your products to look good on the shelf, and the bottom line to look good on your company's income statement. Of course, retail management is more complex than that. But precisely because it is complex, retail marketing and sales executives need a solid, straightforward fact base—and a reliable tool for analyzing that fact base—to help them make better tactical and strategic choices about their marketing investments.¹

Marketing-mix modeling (MMM) is a sophisticated analytical tool that enables retailers to measure the performance of their current

marketing mix and optimize it across advertising vehicles and other touch points, including unique retail levers such as pricing and promotions. Using econometric modeling, MMM helps executives in charge of both tactical and strategic retail management—usually the CMO and the commercial director or head of sales—better understand the trade-offs they face.

MMM typically helps them answer three types of questions:

Performance-driver analysis. What are the true drivers of top-line performance? Which of these drivers are under our direct influence (such as advertising, promotions, and loyalty

¹This article is adapted from Chapter 11 of Dennis Spillecke's *Retail Marketing and Branding: A Definitive Guide to Maximizing ROI*, second edition, West Sussex, United Kingdom: John Wiley & Sons, 2013.

schemes) and which are external factors outside our control (such as competition, overall market growth, economic and demographic trends, and seasonality)?

Impact analysis. What is the impact of various commercial levers on revenue, traffic, and consumer perception? How does the return on investment compare for different line items in the marketing budget (for instance, advertising versus promotions) when applied to a specific market or situation?

Optimization of marketing spend. What is the optimal allocation of marketing and sales funds? How should we split our investments between branded and private-label products? How will budget reallocation influence revenue and profit in both the short and long term?

Ultimately, MMM provides retail managers with the means to investigate the likely consequences of their actions before they act, enabling them to make fact-based decisions instead of relying on intuition. MMM can inform tactical, day-to-day marketing activities (such as campaign design and promotion management), but it can also inform a retailer’s strategic positioning, including its quality and price position, competitive differentiation, cross-format policy, and private-label strategy.

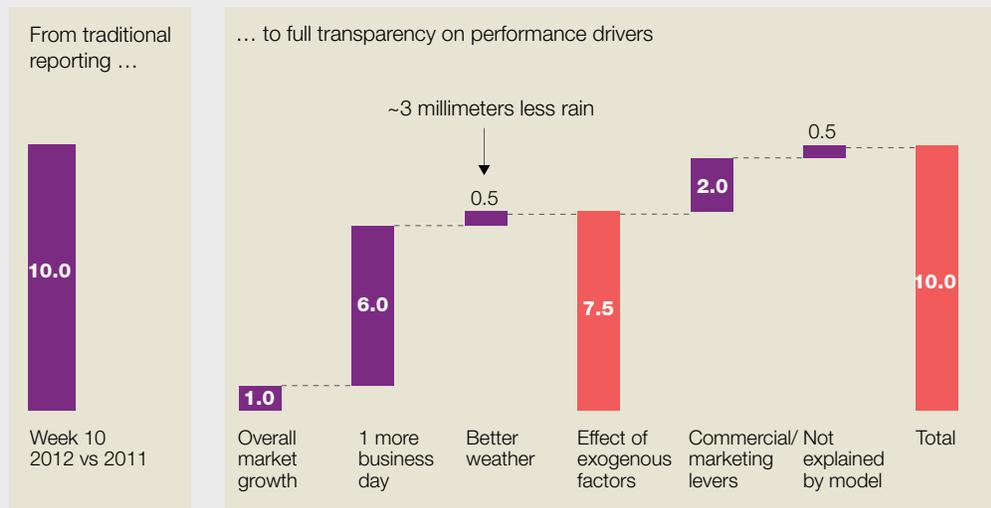
What MMM offers: Transparency across marketing levers

MMM can help executives distinguish between the impact of their actions and the effects of general trends in the market (exhibit). And MMM helps executives understand not only which performance drivers they *should* pull—it also

Exhibit

Marketing-mix modeling allows retailers to identify the drivers of performance.

Revenue evolution, year over year, %



10% better performance

Quantifying the key performance drivers shows that real performance improvement is only 2.5%

identifies the return on investment for the ones they *do* pull or have pulled in the past.

While some activities generate solid profits and others are bottom-line neutral but tactically necessary, the activities that commercial directors really lose sleep over are the ones that are a waste of money. MMM enables directors to spot these activities—and stop them. MMM also helps retailers track how their marketing activities influence consumers' price perception. Although certain activities are beneficial on both fronts (revenue and price perception), others are either long-term investments designed to fuel consumers' perception of the retailer as a provider of good value or purely tactical moves to drive revenue and traffic in a given market environment. Insights about the impact of different marketing activities on revenue and price perception can be combined to shed light on the trade-offs among tactical maneuvers, short-term moves, and long-term strategy.

MMM, however, cannot quantify the effect of various marketing activities on brand image. To avoid damage to brand equity, retail executives should not rely on MMM exclusively for marketing-mix-optimization efforts. Rather, they should use MMM output as the basis for a broader discussion that also takes into account data from other sources, such as consumer research.

How MMM works: Combining science and art

The logic of MMM is simple and straightforward, but its mechanics require a sophisticated blend of science (econometric modeling) and art (deep commercial expertise). Econometrics has been in use for several decades in the consumer-goods industry, but its application to retail is considerably newer. This is due in large part to

recent increases in computational power and platform sophistication, which allow for the automated creation of large data sets and enable retailers to build complex models (for example, separate analyses to explain store sales versus product sales).

An analytical “engine” forms the core of every MMM effort. This engine applies complex statistical techniques to identify each lever—whether it be the CMO's latest loyalty initiative or changes to a competitor's store network—that has a statistically significant influence on sales, traffic, and consumer perception. It chooses, from a range of options, the most appropriate estimation algorithm and regression model and then produces the most mathematically accurate explanation of how the levers influence the dependent variables: revenue, traffic, or consumer perception.

Each retailer should build its own analytical engine, to take account of its unique circumstances, but three key elements are common to all successful MMM solutions: an input database containing information (including in-house data and publicly available market data) from a variety of sources, an econometric model that is refreshed periodically, and a user-friendly software interface.

What MMM requires: Cross-functional teams

The accuracy of the tool is, of course, highly dependent on the quality of the input factors in the database. The data must be accurate, sufficient in both scope (offering at least two years' worth of weekly or daily historical data) and granularity (distinguishing between product categories—say, dairy products and salty snacks—instead of lumping them together in broad departments like

“food”), and consistently updated. And the tool’s data architecture should be fully compatible with the retailer’s existing IT architecture so that data sets can be refreshed automatically as new data become available.

In our experience, only a cross-functional team can ensure the integrity of the data, the calibration of the model, and the correct interpretation of its output. Take advertising spending, for example: the marketing or media director might know which marketing vehicles are relevant, but he or she will need a market-research specialist to figure out how to obtain competitors’ ad-spend data. Only a financial controller will know how third-party ad-tracking information can be made comparable with in-house figures. And only an IT systems manager can determine which formats and file names will fit the model’s operating platform.

Given the data requirements and analytical sophistication, MMM is not a quick fix—but it should not be a one-off effort, either. Its power lies in its continual and consistent application as an integral part of a retailer’s management information systems.



Despite its analytical allure, MMM is by no means a substitute for experience and insight. Rather, it should be considered a complement to—and occasionally, a reality check against—the gut feeling and good judgment of seasoned marketing and sales professionals. It is a decision-support tool, not a retail-management robot. Like any management information system, it depends on the wisdom of its users. ○



This article is adapted from the 2013 edition of *Retail Marketing and Branding: The Definitive Guide to Maximizing ROI*. The authors thank Francesco Banfi, Rishi Bhandari, and Jonathan Gordon for their contributions to this article.

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‘Better every day’: A conversation with the CEO of Ahold

Dick Boer, who has been at the helm of international retailer Ahold for the past two years, talks about the company’s strategy, new initiatives and technologies, and how he sees the retail industry’s role in society.

**Klaus
Behrenbeck**

Food retailing is no piece of cake. In recent years, grocery retailers have had to adapt to drastic changes in consumer behaviors and expectations, the encroachment of new competitors that are luring away once-loyal supermarket shoppers, technological advances reshaping the retail landscape, and economic uncertainty that threatens to reduce already-thin margins. One retailer that has been skillfully navigating these shifts is Netherlands-based Ahold, which operates approximately 3,000 stores—mainly supermarkets—across Europe and the United States.

Ahold’s brands include Albert Heijn; Etos, a drugstore chain; Gall & Gall, a liquor-store

chain; bol.com, an online retailer in the Netherlands; and Albert supermarkets in the Czech Republic. In the United States, the company owns the grocery chains Stop & Shop in the Northeast; Giant Food, based in Pennsylvania; Giant Food Stores, serving the Washington, DC, area; and online grocer Peapod. Ahold also has joint ventures with Scandinavian retailer ICA and Portuguese supermarket operator Jerónimo Martins Retail. Under the leadership of Dick Boer, who became CEO in March 2011, Ahold has achieved steady growth in sales and market share.

Before being named CEO, Boer was chief operating officer of Ahold Europe for more than



Keiko Morimoto

four years and a board member of the parent company for almost as long. He joined Ahold in 1998 as CEO of the company's Czech Republic division, became CEO of Albert Heijn in 2000, and took charge of Ahold's Dutch operating companies three years later. Prior to joining Ahold, Boer spent more than 17 years as a retail executive for various Dutch companies.

In January 2013, Boer spoke with McKinsey's Klaus Behrenbeck at Ahold's headquarters in Amsterdam.

McKinsey: *Recently you've gotten some positive reactions from the financial markets. Which elements of your new strategy do you think investors are responding to?*

Dick Boer: The company has gone through a number of phases, and it would be wrong to highlight only our strategy over the past two years. I think the turning point for Ahold actually came in 2006. At the time, the company was a mixed bag—different brands, different structures, even different businesses, with food retail in Europe and food service in the United States. So the board asked us to do a full review of our business.

That review led to a clear statement at the end of 2006 that our focus would be on food retail, and our focus would be in markets where we were—or could become—number one or two. We sold the wholesale division U.S. Foodservice in mid-2007; we also started moving toward continental strategies, with a clear delineation between Ahold USA and Ahold Europe. We cleaned up our portfolio, we focused on food-retail operations in the larger markets, and in some areas we reinvested capital. Essentially, we laid the groundwork for regaining credibility

among our stakeholders, both internal and external. And I think that phase delivered at least a couple of years of sustainable performance to the markets.

But we also needed a strategy to move forward as an organization. When I became CEO, I was very focused on getting the company to the next level. We needed to show the market that we have a strategy for growth. We started working on our next phase—and that led to our current strategy, “reshaping retail.”

I think we had a few things going for us already at that time. We'd decided in 2008 and 2009 to close down our hypermarkets and focus on supermarkets, convenience and smaller-store concepts, and the online channel—all mainly to help fulfill the daily needs of consumers. We felt that was our domain, what we were good at. We also had the benefit of a diverse and highly skilled team, both in the United States and Europe, that we'd built over the last few years.

McKinsey: *Say more about the decision to focus on supermarkets, convenience, and online. How do those three things work together? Or do you think of each one as a separate business?*

Dick Boer: To understand global trends in retail, you have to look at things from the perspective of a customer who can get everything via the Internet. Ten or twenty years ago, you had to go to a hypermarket. I opened my first hypermarket in the Czech Republic in 1998, and it was a big event; we had traffic jams outside the store. We had 50,000 to 60,000 SKUs in one store, from electronics to food. Today, you can get many of these things online, so you don't need to go to the store.



Dick Boer

What we've learned over the past ten years is that supermarkets ought to focus on the experience of fresh foods; that's the name of the game for supermarkets. The freshness of foods in the supermarket gives the customer a reason to go to the store. I also think convenience—having your goods readily available and near the customer—is important. Supermarkets are convenient for weekly shopping trips, but smaller stores are a great opportunity to get closer to the customer. On top of that, I believe you have to have an online offering as an extension of the store. The more variety you have, the more interesting the proposition becomes for the customer. Customers want to be surprised at what they can find online—maybe the authentic Tuscany olive oil isn't on the store shelf, but you can find it online. So that's my view on food retailing today: freshness, convenience, and a large online offering are key.

McKinsey: *All three elements are evident in what you're doing in both Europe and the United States—but you're doing it under several different brands. Do you think you'll continue to manage your portfolio on a brand-by-brand basis?*

Dick Boer: We know some global retailers that have been very successful in pursuing a one-brand strategy, but I think that's more logical in nonfood areas than in food. Our brands have a local heritage, and customers have a long relationship with those brands—so to change those local brands into one global brand is not in our plans.

Our local brands are strong assets. What we've done, though, is give our local brands a common language: our promises, along with our values and our business model and our six strategic pillars. This single page (exhibit) tells you the story of Ahold. We are a global family of local brands, and it's a global family that views things the same way. That's new for us—in the 15 years that I've been working at this company, I think this is the first time we've found a good way of keeping our local positioning while also having one global strategy that our more than 200,000 employees all talk about and work on.

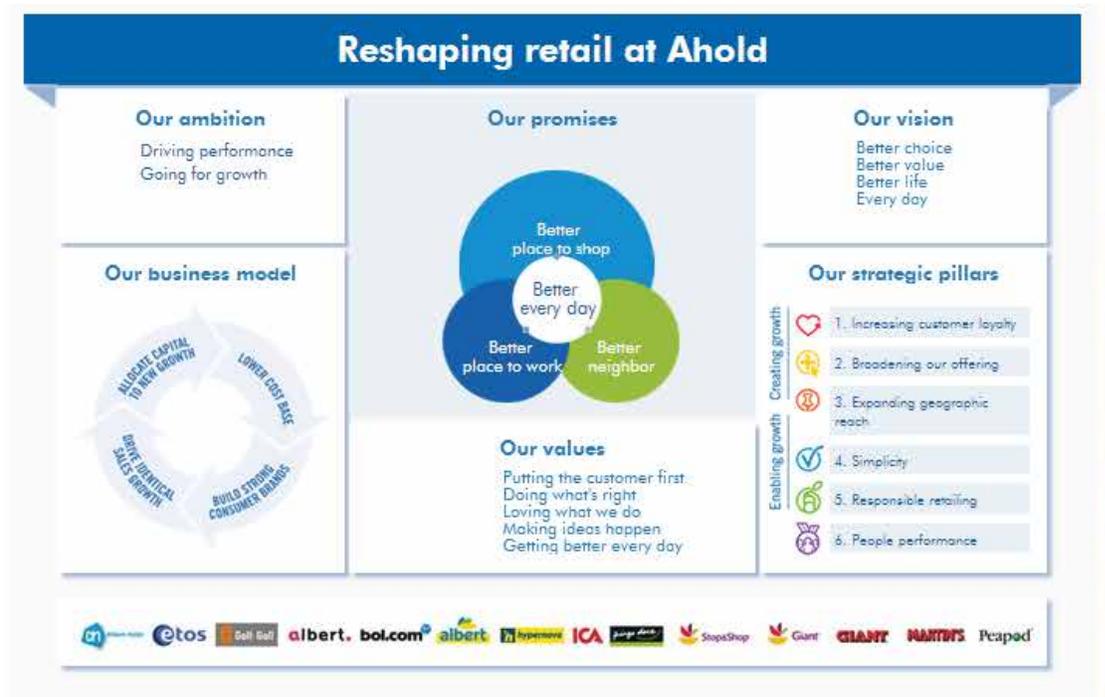
We've defined three promises—to be a better place to shop, a better place to work, and a better neighbor—with the simple overarching message that we should be “better every day.” These promises bring us from a pure local-banner proposition to having a global language that our employees can apply locally in their business.

For each of the three promises, we have a clear understanding of how we're going to measure ourselves, both in hard key performance indicators and in perception. We're not just looking at the real price difference between us and our competitors—say it's 3 percent—but also at the customer's perception of the price difference, which might be 7 percent. Or if we believe we are strong in fresh food, but the customer gives us an average rating of six on a scale of ten, or three on a scale of five, then we would say we're still not good enough.



Exhibit

Ahold's global strategy provides a 'common language' for its employees.



McKinsey: *It appears that one area in which customers are giving you high ratings is your online channels. How do you see Albert.nl, bol.com, and Peapod evolving?*

Dick Boer: I believe we have to give customers multiple ways to do their shopping. My vision is, wherever you are, you should be able to order and buy our products. Either you go to the supermarket for a planned visit, stop at a smaller store for convenience when you're on the run, or do your shopping on the Internet or your iPhone, and then pick up your order or have it delivered. We need to have an integrated approach so that our customers can shop wherever and whenever they want.

We always kept our online business—even in the most difficult time in 2003, when it would have been easy to get rid of the loss-making stuff and just focus on the things that were making money. But we always believed in the online channel, and now our online business has a long history.

Our goal is to reach €1.5 billion in online food sales in 2016. We want bol.com, for example, to continue having double-digit growth, and there are many opportunities to do that. First, we can expand into new categories; bol.com introduced three last year, and this year we'll introduce a few more. Second, we can tap into more regional markets; we expanded into Belgium a couple of

years ago, and it's been going well. Third, we can build our infrastructure of pickup points. We now have 60 bol.com pickup points in Albert Heijn stores, and this will expand rapidly in 2013.

McKinsey: *And you're opening more pickup points, not just for bol.com but also for your other store banners, right?*

Dick Boer: Yes. We concluded that home delivery is great but also has limitations. Although you can say, "I want to have my order delivered between 2 and 4 in the afternoon or between 6 and 8 in the evening," you still have to be at home to receive the delivery. Last year, we identified pickup points as something we needed to test. So far, customer reactions have been very encouraging. Since November, we've opened three Albert Heijn pickup points in the Netherlands.

We're thinking about different options. We've just opened stand-alone pickup points near highway exits. It's a very simple thing: a 20-square-meter box with a small parking lot. You place your order online or on your mobile phone, and then you get a message that it's ready for pickup, along with a code. You punch in the

code when you get to the pickup point, we tell you which parking space to park your car in, and an employee comes to your car with your groceries. You're done in two or three minutes, and that includes the payment process.

The orders are prepared in special warehouses dedicated to online sales, and then they're brought to the pickup point. So this looks to be a promising initiative that fits very well with our strategy, as it helps increase customer loyalty and broadens our offering. By the way, I think pickup is also a great opportunity for the United States, because people there travel so much in their cars.

McKinsey: *Do you regularly export innovations from one part of the world to others?*

Dick Boer: There are some skills and concepts that I think are important to export. For example, we have a high-efficiency, low-cost supermarket model that's been successful for us in the Netherlands, and we've been able to bring it into the Belgian market. Most high-efficiency models are discount-oriented stores, but this is a high-efficiency supermarket with a high service and quality level.

I believe we have to give customers multiple ways to do their shopping. My vision is, wherever you are, you should be able to order or buy our products.



Another important asset that we've exported is our ability to build a brand strategy. We built our own brand strategy here in the Netherlands, and that experience helped our US businesses, which have just been through an intense period of developing their brand strategies.

It goes in the other direction as well. We've made a lot of progress in the United States on personalized offers and customer-reward systems, so we're transferring that knowledge from the United States into Ahold Europe.

McKinsey: *Among the innovations you've introduced, both in Europe and the United States, are mobile applications. Do you see these new technologies generating meaningful sales in the near future?*

Dick Boer: I think the features on mobile devices—whether tablets or smartphones—will soon be the same as the features on your home computer. Take our “Appie” application: it allows you to share recipes and shopping lists with your

friends or your partner or your children, and they can add to the shopping list when they're on their devices; you can order groceries for delivery and specify delivery times. Appie has voice recognition and a bar-code scanner. Mobile devices will only become more important, especially when we get 4G and faster Internet.

And the devices can go even further. One thing we're testing in the United States is mobile payments. Right now, you can pay using an NFC¹ chip, but you have to put the chip in your phone and load it and reload it, so I would say it needs to become more convenient. We also need to better integrate our loyalty cards with smartphones. Today, you can place orders on Appie and it has all your customer data, but if you go to the store you still have to identify yourself with a loyalty card. I think eventually the cards will be replaced with new technology—but it might take longer than everybody thinks, because there are people who never use one or the other, so you need to offer both. In any case, as an industry, we can't stay out of mobile devices and technology.

¹Near-field communication.

We will have nine billion people to feed in 2050. On the other hand, there are concerns about animal welfare and production of raw materials. We can't focus on just one or the other; we somehow need to balance them all.

McKinsey: *Let's talk about private label. Retailers everywhere are becoming more sophisticated at it. What's your private-label strategy?*

Dick Boer: Although we continue to grow our private-label business, our stores need product variety—we have to have a good offer of A brands and private brands together. So it's a balancing act. We have a sales target in the United States of 40 percent private label, and we're well on our way to getting to that level. It's still lower than Europe; Europe is more in the 50 percent range. But the market circumstances are different: at least in the Netherlands, but also I think in the United Kingdom and some other markets, you see a higher share of private label because we have limited space. We have to manage and balance every square centimeter in our stores. Space isn't a problem in most US stores, so they can have greater variety, and American customers want to have larger selections.

McKinsey: *One final question: something you've emphasized at your company—and it's a big topic for many other retailers as well—is corporate social responsibility, or CSR. To what extent is CSR part of the value proposition of your brands?*

Dick Boer: First, it's important to note that CSR—or “responsible retailing,” as we call it—is an integral part of our strategy, as reflected in our six pillars. Of course we have our organic products—Pure and Honest here in Europe and Nature's Promise in the United States, which is huge. But I think CSR is more than just organic products.

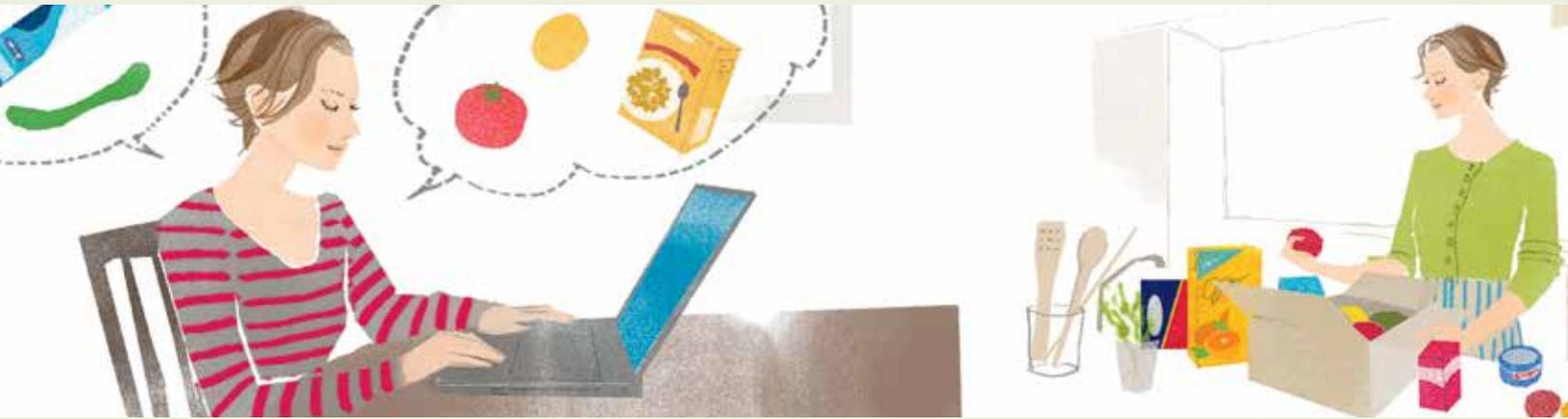
We think about CSR in four areas. First, we need to be transparent in our product sourcing. At the end of the day, our sourcing should be good for society. Second, we want to help our customers and our employees live healthier lives. We want 25 percent of our products in the stores to be healthy products, marked with one of our “healthy living”

logos. Third, we want to decrease our climate impact, for instance, CO₂ emissions. We're doing things like changing our refrigerators and coolers to save energy. Fourth—and this may be the most important—we want our supermarkets to really be part of the community. That can be through supporting food banks, or it can be through helping the communities around our stores. For instance, most of the time, retailers with stores in depressed or low-income neighborhoods start thinking about moving out of those communities, but we believe we should rebuild those stores and help them become the social center or the heart of those communities that are in a bad situation. These four themes are part of our promise to be a better neighbor. It's an important promise, and I believe you can never do enough.

One challenge is that there are conflicting demands, and they all need to be considered. For example, on the one hand, on a global scale we

will have nine billion people to feed in 2050. On the other hand, there are concerns about animal welfare, production of raw materials, and so on. We can't focus on just one or the other; we somehow need to balance them all.

We as an industry, and at Ahold, have to prove that we can be better every day. I strongly believe that, to be able to meet the needs of nine billion people 40 years from now, we must take even more fundamental actions together to be sure that we fulfill our responsibilities, whether it has to do with water conservation, or sustainable production, or obesity. There is a role for us as an industry to help people use the things we sell in the best way—for their health, for the community, and for future generations. ○



The future of online grocery in Europe

The online-grocery market is poised for growth. But only early movers will win—and only if they are adept, disciplined, and agile.

**Nicolò Galante,
Enrique García López,
and Sarah Monroe**

Just because Europeans aren't buying groceries online en masse doesn't mean they don't want to. In fact, many of them love the idea of saving time by not having to trek to a supermarket, push a shopping cart down aisle after aisle, then wait in the checkout line. The convenience of shopping for groceries online is alluring.

But convenience isn't everything. Consumers will shop for groceries online only if the offer is right: they're not willing to sacrifice the price, quality, and range of products that they've grown accustomed to in the supermarket, and they won't put up with inconvenient delivery or pickup arrangements. To date, few European retailers

have given consumers a compelling reason to switch from the neighborhood grocer to the Web.

That could soon change. Based on our latest research, we believe the advent of the "click and collect" model—which allows customers to place orders online and pick them up at a store or other designated location—could entice more retailers, as well as more consumers, to the online-grocery space.

Nevertheless, getting into e-commerce isn't a trivial matter for a grocery retailer. Will the payoff be worth the investment? Our research, which included a survey of more than 4,500 European



Toko Ohmori

consumers in France, Spain, and the United Kingdom, as well as a global scan of best practices in online grocery, strongly suggests that the answer is yes—for retailers that move quickly. Online grocery will play out differently in each country and for each retailer depending on margins, current market share, and other factors, but in general the value at stake is high and the market will change rapidly. Only early movers will win—and only if they have an outstanding value proposition, a relentless focus on profit optimization, and a willingness to place big strategic bets.

Poor supply hampers demand

With a few exceptions (such as in the United Kingdom, where Tesco and pure-play retailer Ocado have made assertive moves), Europe's online-grocery market has been stuck in a vicious cycle: poor supply drives low demand, which in turn justifies the poor supply.

Many retailers are put off by the economics of the business: selling groceries online means taking on additional costs—in labor, delivery vehicles, and fuel—that are higher than the fees customers are willing to pay for delivery (which, according to our research, is between €4 and €7 per transaction, depending on the market). Profitability can thus seem an unattainable goal. This is particularly problematic for retailers in markets where gross margins are lower and labor costs are higher relative to the United Kingdom.

Some of Europe's grocery retailers have ventured into online selling, but in general their efforts have been tentative and half-hearted and thus have failed to win customers; their underfunded Web sites feature mostly limited and overpriced assortments. In France, only about a quarter of consumers who have shopped online for groceries once continue to do so regularly. Lapsed online shoppers told us that reduced assortments, higher prices, and additional fees had driven them back to supermarkets (Exhibit 1).

Another factor keeping demand low is consumer skepticism about product quality. In all the countries we studied, consumers who haven't yet tried grocery shopping online said their biggest concern is not being able to see or touch the actual products before buying. They want reassurance that their groceries will be fresh and high quality—no bruised fruit, no wilting lettuce.

There is, however, latent demand. In France, 33 percent of consumers who have never bought groceries online say they would “probably” or “certainly” begin to do so within the next six months if the service were available in their area. In Spain, that figure is even higher, at 49 percent. Breaking the vicious cycle will require just one retailer in every market to step up and take the lead.

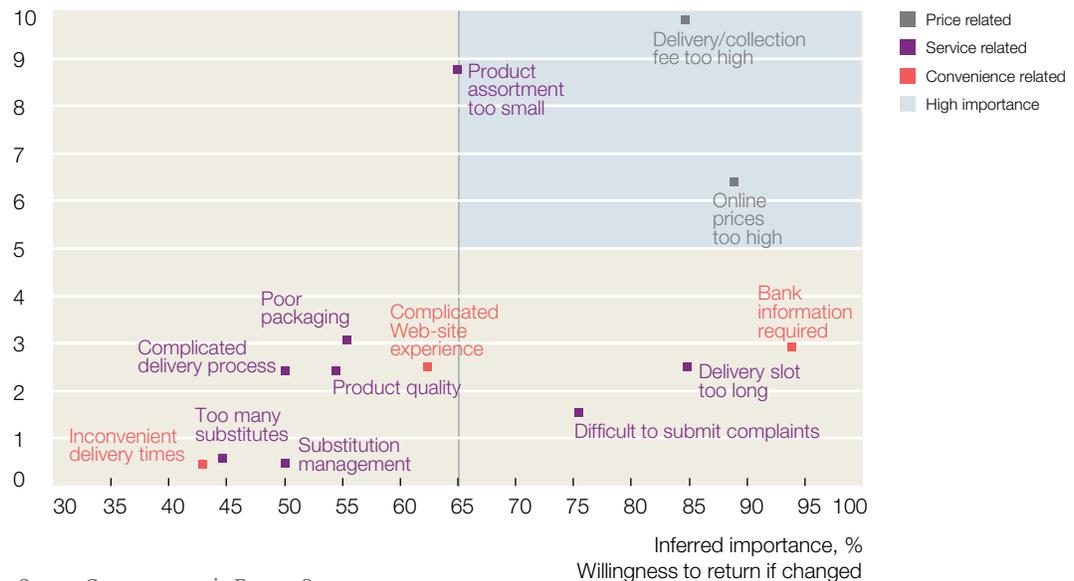
Although Europe's online-grocery market has been stuck in a vicious cycle, there is latent demand from consumers.

Exhibit 1

Lapsed online shoppers say price and assortment are critical.

Nonusers who have tried and stopped

Stated importance, %



Source: Grocery survey in France, Q4 2011

Click and collect: A tipping point?

It appears that such a development will happen soon. A few European retailers, notably in the French market, have recently launched a service that just might mark the tipping point for online grocery: “buy online, pick up in store,” or click and collect. This model gives retailers easier entry into the online-grocery space, since it has much less daunting economics than home-delivery service. Our analysis shows as much as a 30 percent difference in margin, making it easier for a retailer to justify the investment (Exhibit 2). Furthermore, pickup does not require scale in the same way delivery does and is better adapted to

basket-size variations (because larger pickup orders don’t necessitate more delivery trucks).

And it’s a service that appeals to consumers. A significant fraction of Europeans are at least as favorably disposed toward pickup as they are toward delivery. Many survey respondents said they pass a grocery store on their daily commute anyway, and they don’t like having to wait at home for a delivery. That said, given the distinct consumer segments preferring delivery over pickup, winning retailers will most likely offer both options, at least in densely populated areas (Exhibit 3).

Exhibit 2

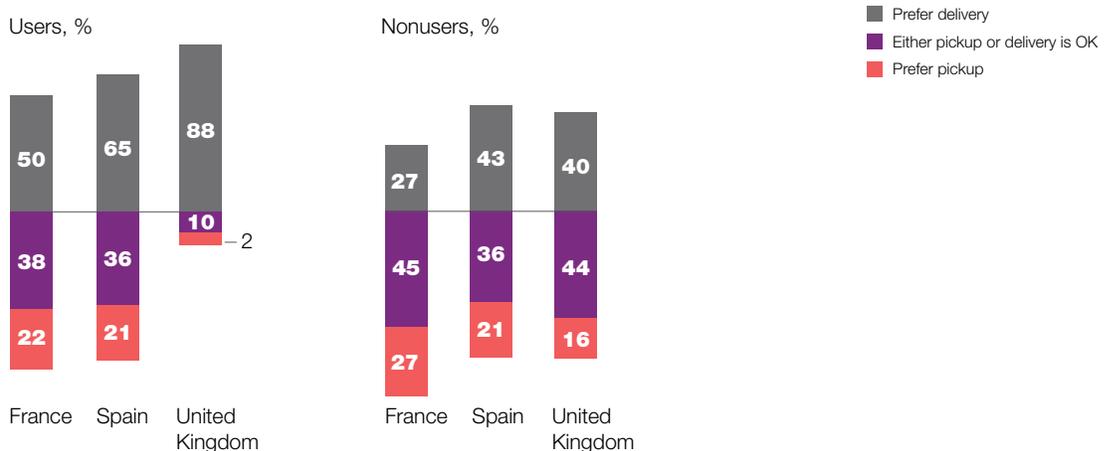
The economics of pickup can be substantially more attractive.

Differences per model, best-case economics in high-density area with low labor costs, €/order



Exhibit 3

There are distinct consumer segments for pickup and delivery, so a mixed model is advisable.



Opportunities and challenges in a multichannel world

It's clear that digital technologies are transforming the retail and consumer-goods landscape. This article on online grocery is part of our broader thinking on consumer digital excellence (exhibit), to help companies think through critical questions on the following topics:

Strategy. What are our “must win” category battlegrounds? What role should each channel play by category? What strategic bets should we make on emerging platforms such as smartphones and tablets? How will digital technologies shape the store of the future?

Digital-sales stimulation. What are near-term opportunities to boost our e-commerce traffic, conversion rates, and average order values? How can we harness Web data to achieve a step change in customer-life-cycle management?

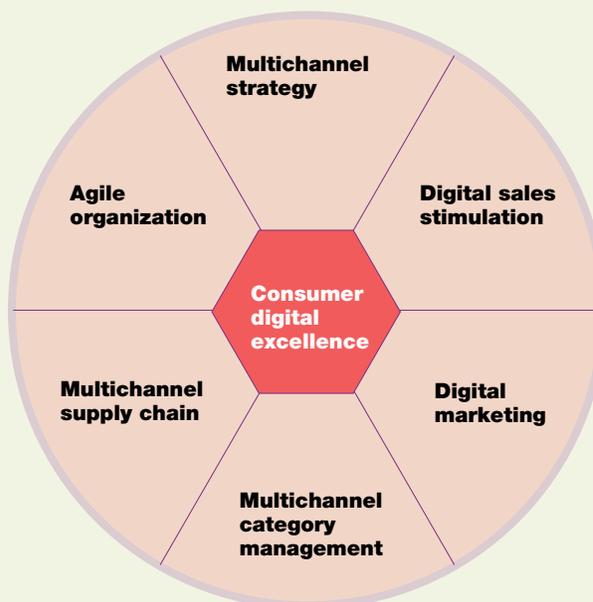
Digital marketing. Within the multichannel “consumer decision journey,” on which touch points should we focus? How can we use social media and Web data to optimize our marketing spend?

Category management. What should our multichannel pricing, promotions, and assortment strategy be?

Supply chain. How far from best in class are our supply-chain capabilities? How can we use digital technologies to improve our operational processes and increase visibility throughout our supply chains?

Agile organization. What capabilities should we prioritize, and how do we build or acquire them? What metrics, processes, and structures are required to make our digital plans a reality and best position us for an uncertain future?

Consumer digital excellence entails a number of elements.



Recent developments in France illustrate how pickup can fuel explosive growth: since 2006, retailers have established approximately 1,000 pickup points in the country. This pace hasn't been seen since the boom in hypermarkets in the 1970s. And pickup has tapped into latent demand: of French consumers who now regularly buy groceries online, 42 percent just began doing so in 2011.

Granted, at the industry level, the rise of the pickup model isn't all good news. A shift from physical stores to online will reduce margins: retailers will have to take on the additional costs of labor and picking long before they can shed operating costs by shuttering physical stores. Furthermore, not all online sales will be additive; a significant fraction of online sales will cannibalize the offline business.

But online grocery can be a boon to early movers. As markets from the United Kingdom to France to Switzerland have demonstrated, a strong online offer can win customers away from competitors and capture additional market share, compensating for lower margins. Our research shows that consumers tend to be disloyal as they learn to shop across channels, with 64 percent switching preferred retailers when migrating from brick-and-mortar stores to the Web (Exhibit 4).

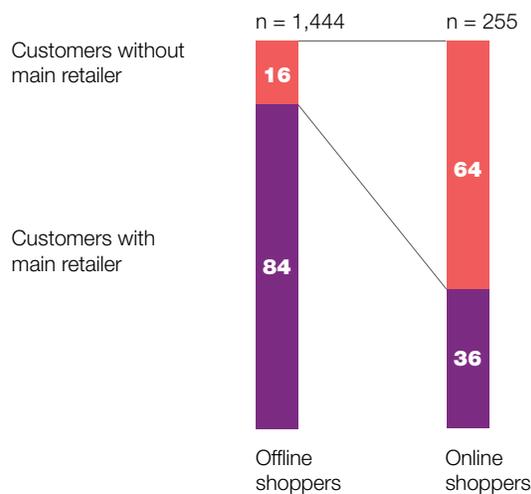
How to be a market shaper: Three principles

Once a retailer makes an assertive first move in online grocery, others are likely to follow suit. But at that point, the business case for investing in online grocery will be a matter of defending market share and preventing further losses—not delivering incremental profit. In a rapidly changing market, waiting can be costly.

Exhibit 4

Shoppers switch retailers when they switch channels.

%

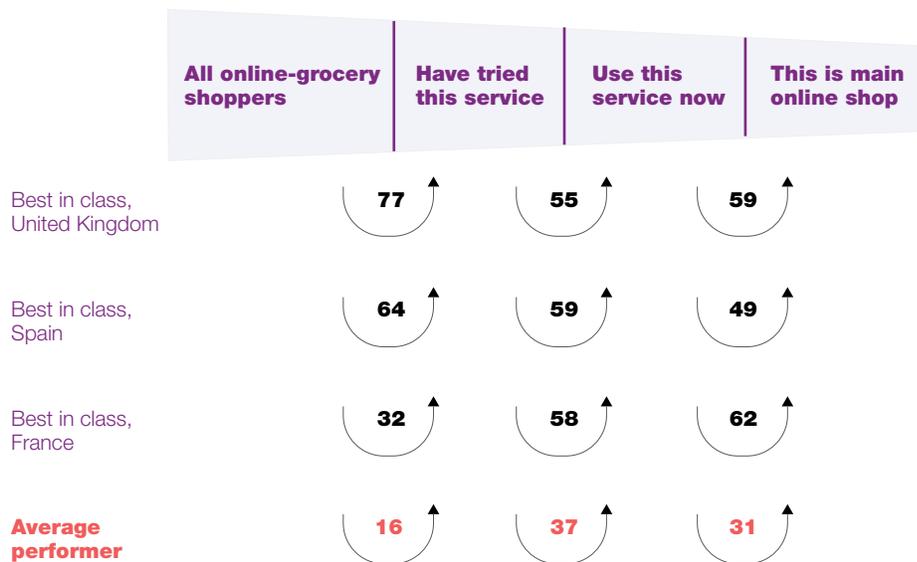


Source: Grocery survey in France, Q4 2011

Exhibit 5

Performance varies wildly, with one player setting the bar in each market.

Regular and occasional online shoppers, %, n = 600



Our experience working with retailers across Europe, combined with our proprietary consumer research, brings to light three things that will set the market shapers apart: a truly outstanding online offer, a disciplined insistence on profit optimization, and a strategic approach to online grocery.

'Good enough' isn't

In the online world, there's a vast difference between a "good enough" proposition and an outstanding one—and only the latter will attract and retain customers. In each of the countries we studied, the most successful online-grocery player is markedly better at converting consumers into customers at each stage of the purchasing funnel (Exhibit 5).

Unfortunately, some of Europe's online-grocery stores aren't even "good enough" when it comes to Web design and functionality. Features that are a matter of course in more mature markets like the United Kingdom—high-quality photographs of products; clear labeling of brands, prices, and pack sizes; and smart search algorithms, including spelling autocorrections and "did you mean" suggestions—appear inconsistently or not at all on grocery Web sites in Europe.

Retailers must recognize that the online user experience is even more important in grocery than in nonfood categories because of the number of items in a typical grocery transaction. Grocery shopping is laborious and time-consuming on a badly designed, poorly functioning Web site.



Convenience is important, but quality, assortment, and price also matter tremendously. The value proposition—and, of course, the marketing messages—of online grocers should reinforce these elements.

First-time users won't return to a site that they find difficult to navigate.

And because convenience is a core element of online grocery's value proposition, causing any inconvenience to the customer is almost a guarantee of losing that customer forever. The consequences of a retailer's poor performance in online grocery—whether on the Web site itself or as part of the delivery or pickup arrangements—are likely to be highly frustrating for customers: a site crash in the middle of an order can mean the customer has to add each item to her shopping cart all over again, unclear labeling on the site can lead a customer to order the wrong items, a late delivery can ruin dinner plans.

Convenience is important, but quality, assortment, and price also matter tremendously. The value proposition—and, of course, the marketing messages—of online grocers should reinforce

these elements. FreshDirect's success in Manhattan, for instance, has been due not only to the convenience of its delivery service but also to an outstanding value proposition: higher quality at lower prices.

Relentless profit optimization is key

Online grocery can be profitable, as the best performers have shown—but only through maximum operational and marketing efficiency. In our scan of online-grocery operations worldwide, we came across wide variations among the best and worst performers on a range of operational metrics. Take picking costs as an example. The top performers, by implementing best practices such as the use of easy-to-maneuver picking carts and careful monitoring of pickers, have boosted their picking speeds to three times those of the worst performers—the difference between profit and loss.



The Web site’s “engine” can also drive profit. Many online-grocery sites in Europe today are missing critical basket-building features such as contextual product recommendations (based on the consumer’s previous purchases, for instance), product-by-product access to recipes, or the ability to recreate a prior order with a single click. Such features can yield a 5 percent bump in average basket size—again, the difference between a profitable business and a money-losing operation.

The doctrine of ruthless optimization also applies to marketing spending. Discount-driven customer acquisition is prevalent; many online grocers offer 10 percent off the first order. Retailers must understand the customer lifetime value of each customer segment in order to determine the right level of investment. One leading European online

grocer, for example, sets delivery fees based on basket size and time since last order, giving shoppers incentives to buy more and buy often.

[Playing strategically means betting big and being agile](#)

Retail leaders who believe in the potential of online grocery must be prepared for the possibility of internal opposition; they will have to make a very strong case to management and shareholders. No retailer will shape the online-grocery market unless it is willing to go “all in.” An incremental approach—store by store, for instance, or one product category at a time—will fail.

Once a retailer decides to invest, it faces important decisions about the fulfillment model and last-mile operations. For example, picking can be done in stores, small dedicated

warehouses, large fulfillment centers, or some combination of these options. Customers could receive their purchases via home delivery or by picking them up inside the store, in a store's parking lot, at a dedicated pickup facility, or at a designated third-party location (such as a gas station). Each model will have different economics and investment requirements depending on the retailer's distribution footprint, price positioning (discount versus premium), scale, geographic concentration of sales, and competitive environment.

Playing strategically also means optimizing for local contexts, taking into account the target customers, economics, competitive landscape, and level of cannibalization (that is, how much online sales will eat into the offline business) in each neighborhood. The right model for an urban neighborhood dominated by competitors' stores will be different from the right model for an affluent suburb in the retailer's core market.

We believe that in most markets, large retailers will very soon invest in online grocery. However, there's little clarity about how much margin will

be on the table in the long term, how much consumer demand will materialize for pickup versus delivery, and how aggressive—and successful—new entrants will be in each market. Retailers must assume that the business environment will evolve, plan for a range of scenarios, and be prepared to adjust their offer accordingly. Tesco, for instance, began with in-store picking, then switched to a dedicated-warehouse model; it began with only a delivery service but now offers click and collect as well. The ability to anticipate and adapt to changes in the marketplace will be crucial.



New formats in grocery come along infrequently, and when they do, they tend to take incumbents by surprise—leading to a significant redistribution of market share. In most developed markets, online grocery is at a tipping point. Only retailers that move quickly and assertively can shape the market and win. ○

The authors thank Remi Said and Patrik Silen for their contributions to this article.

Nicolò Galante is a director in McKinsey's Paris office, **Enrique García López** is a principal in the Madrid office, and **Sarah Monroe** is a principal in the London office. Copyright © 2013 McKinsey & Company. All rights reserved.

Is your online marketing any good?

Reliable competitive benchmarking of online-marketing efforts has been elusive. A new Web-based tool can help.

**Fabian Hieronimus
and Mathias Kullmann**

The Internet and online marketing have evolved quickly. Marketers are allocating ever-larger portions of their budgets to online channels: global spending on online marketing has grown at a clip of 55 percent annually since 1995.¹

With this increase in spending, marketing executives need to know whether they are spending their money well. However, there is no standardized, widely accepted approach to measuring a company's online-marketing performance. Rankings can offer some indication of a company's competitive position, but they are usually limited to one or two metrics (for example,

the number of unique visitors or click-through rates). Many data points on specific segments and subsegments of the digital market exist, but determining what data to focus on and which sources to use can be perplexing for even the most seasoned marketing executives.

To help companies gauge the strengths, weaknesses, and improvement potential of their online-marketing efforts, McKinsey partnered with Google to develop the Online Marketing Excellence (OMEX) dashboard, a Web-based tool that gathers data on nearly 30 digital-marketing key performance indicators (KPIs).

¹Kleiner Perkins Caufield & Byers, *Relationship Capital: Internet Trends*, presented at the Web 2.0 Summit, San Francisco, California, October 18, 2011.

Insights for retailers

Using OMEX 2.0, we analyzed more than 100 large multichannel retailers in Europe—and found that the keys to online excellence resemble the time-tested strategies for offline success: being strategically located, creating an attractive environment and a memorable shopping experience, and nurturing loyal customers.

Be where the people are. The strength of a retail business, whether offline or online, depends on location. Online, the best locations are at the top of the results generated by search engines and, increasingly, in the largest social-media networks. The players best positioned along these main traffic arteries—the online equivalents of the Champs Élysées or Germany’s Königsallee or Kurfürstendamm—are the most visible to potential customers. And engaging with consumers on social media pays off: our analysis shows that companies with above-average activity on popular social networks have up to 75 percent higher per capita revenues than retailers without a social-media presence.

Make shopping fun and easy. Brick-and-mortar retailers must ask themselves: is the store attractive and inviting, and can customers find their way around easily? The same questions apply to online stores: does the home page have

an appealing design? Are the search functions and navigation easy to use? Are products well presented on screen through high-impact photos and clear descriptions? Another question is crucial for the offline business: does the Web site make sufficient use of cross-selling opportunities? One telling KPI that OMEX measures, for instance, is research online/purchase offline, which takes into account an amalgam of online features—such as store locators and printable coupons—that make it easy for Web visitors to make purchases at physical stores.

Keep them coming back. Customer retention is cheaper than customer acquisition. Online marketers that go out of their way to cultivate regular customers through loyalty campaigns outdo competitors both in visit frequency by unique customers and in the number of purchases per visit. Some apparel retailers, for example, have sophisticated incentive systems that include contests, sweepstakes, and discounts exclusively for returning customers.

OMEX 2.0 at a glance

The basic OMEX 2.0 dashboard shows how a company stacks up against its chief competitors in each stage of the consumer decision journey: initial consideration (exhibit); active evaluation, or the process of researching potential purchases;

We analyzed more than 100 large multichannel retailers in Europe and found that the keys to online excellence resemble the time-tested strategies for offline success.

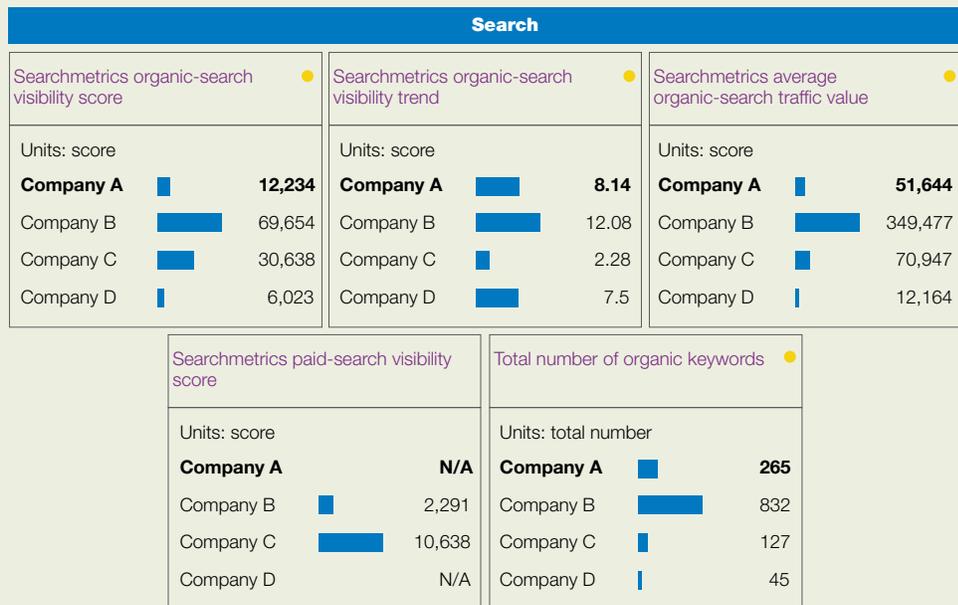
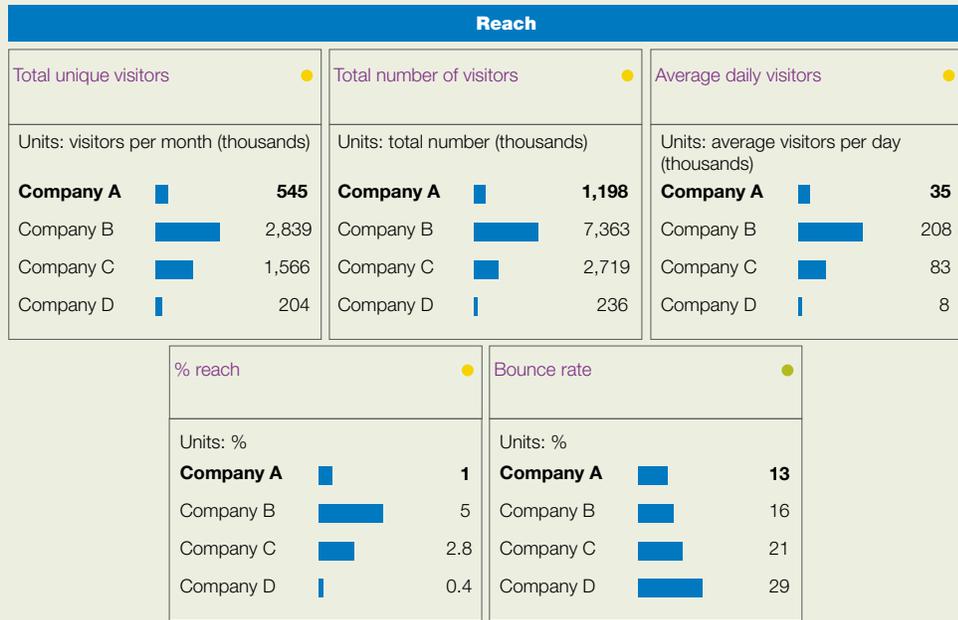
Exhibit

Online Marketing Excellence, or OMEX, is a Web-based tool that delivers data on more than 30 online-marketing key performance indicators.

Traffic-light colors indicate the relative performance of Company A compared with its competitors

- Company A is best in class
- Company A is midfield
- Company A is last in class

Initial consideration



closure, when consumers buy brands; and postpurchase, when consumers experience them. OMEX 2.0 uses KPI data from specialty providers including Alexa Internet, comScore, and The Nielsen Company.

It also allows for the creation of an extended dashboard, which includes the KPIs from the basic dashboard as well as qualitative analyses on topics such as Web-site usability, online assortment, and the linkage between online and offline channels.

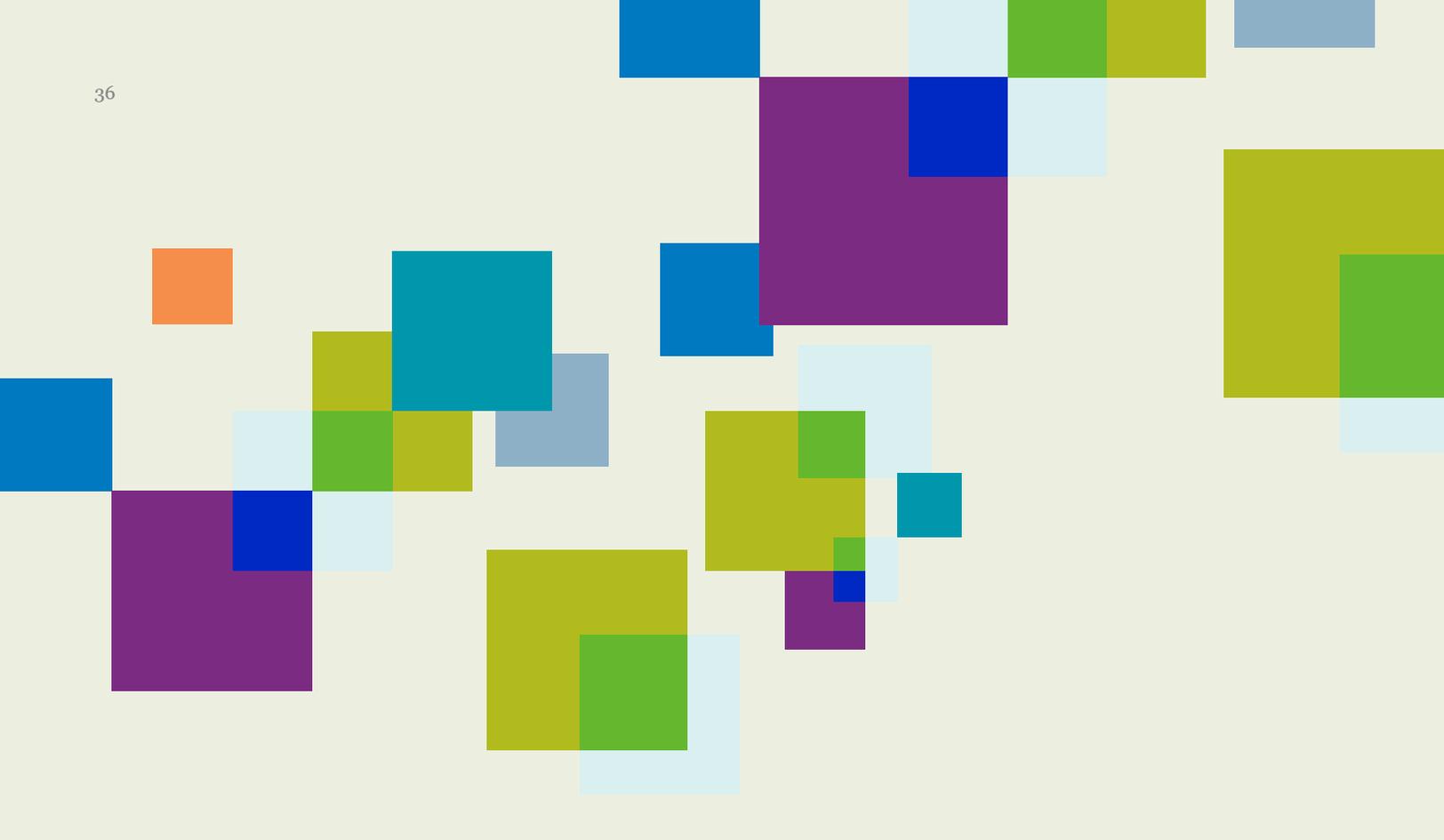
OMEX is unique in that it uses KPIs that measure not just the number but also the quality of Web visitors, which it does by excluding users who view only one page of the Web site—a metric commonly referred to as the “bounce rate.” Additionally, OMEX links input metrics (such as ad spend) with output metrics (such as unique visitors), whereas many existing tools measure only one or the other. One of the KPIs on the OMEX dashboard, for instance, is “quality traffic versus total ad spend”; this indicates, for every marketing dollar a company spends in a given month, the number of

unique quality visitors its Web site attracts in that same month—an important measure of how efficient a company’s online spending is.

Companies have used OMEX 2.0 as a starting point from which to develop a comprehensive digital-marketing strategy. For example, a leading European grocery chain’s OMEX 2.0 dashboard showed that, relative to its competitors and to analogous retailers outside the grocery industry, the company’s online marketing was unfocused and costly, its Web-site features and functionalities were weak, and its social-media presence was not registering with consumers. Based on these insights, the company redesigned its Web site, increased its investment in digital channels (specifically, targeted display ads and search-engine advertising), and developed and implemented a social-media strategy. These changes yielded impact almost immediately: the company’s cost per contact fell by nearly 40 percent, and its profit per euro invested in online marketing increased from a starting point of 20 percent to 120 percent. [O](#)

The authors would like to thank Jochen Böringer, Max Fischer, Viola Heuer, Johannes-Tobias Lorenz, Christine Prauschke, and Google’s OMEX 2.0 Team for their contributions to this article.

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Experimenting without risk at the Digital Marketing Factory

In an experiential-learning center in Munich, marketing and sales professionals gain hands-on experience with digital-marketing tools and methods.

**Jürgen Schröder and
Dennis Spillecke**

The Internet's growing importance has created great opportunities—and some concern—for businesses. At McKinsey's recent Chief Marketing and Sales Officer Forum, attended by representatives from about 150 companies from multiple industries, 72 percent of participants stated that digital media is crucial to their companies' continued success. But a similar number—80 percent—said they felt unprepared for the digital challenge.

To bolster their digital skills, some companies are sending staff to training programs that give participants hands-on experience with digital-marketing tools and techniques. One such program is the Digital Marketing Factory (DMF).

Established in 2011, the DMF is located at the McKinsey Capability Center in Munich, an experiential-learning environment that houses capability-building programs for several functional areas including product development, pricing, and customer service.

Numerous companies—including a consumer-electronics retailer and a company that operates airport stores—have sent employees to the DMF. Participants can choose from two training programs: a one-day workshop targeted at board members and heads of marketing and sales or a two-day workshop for operational managers and employees that includes additional content on applying digital tools.

DMF training includes a discussion of online customer behavior and a strategy session that provides a general overview of digital media. The centerpiece of the DMF is Vinoya, a real online merchant that sells more than 4,000 international wines to customers throughout Europe (Exhibit 1). McKinsey founded Vinoya specifically for use in the DMF and continues to own the brand. During each training session, up to 20 participants collectively act as Vinoya’s chief marketing officers—they have a budget, design the company’s online strategy, and assume responsibility for driving online traffic and sales

for the duration of the session. Workshop exercises vary depending on audience needs, but all participants focus on mastering operational and strategic tasks. Examples of workshop challenges include the following:

Building a display ad. DMF trainees may be tasked with creating targeted display ads on Facebook for Vinoya’s “Wines that Rock” collection, an assortment named after famous bands from the 1960s to the 1980s. As they would with any campaign, participants must first determine the target customers for the collection—

Exhibit 1

Online wine retailer Vinoya was created for use in the Digital Marketing Factory.

The screenshot shows the Vinoya website interface. At the top, there is a logo for 'VINOYA WINE FOR ME ...' with the tagline '4000 Weine aus aller Welt'. A search bar is located in the top right corner. Below the logo is a navigation menu with options: HOME, WINE, STYLE, SPARKLING, TOPICS, GIFTS. On the left side, there is a 'Range' section listing various wine categories like Red (1844), White wines (823), Rosé (95), Sweet (48), Tingly (231), and Port / Sherry (413). The main content area features a 'Wines that rock!' promotion for 'Weinliebhaber und Musik-Fans', highlighting 'Pink Floyd' and 'The Police' wines. Below this is a section titled 'Red wines with an excellent price / benefit ratio' displaying four wine bottles with their respective prices: La Motte Millennium 2009 (€ 16.80), Salvador Poveda Toscar Monastrell Tinto 2008 (€ 4.50), Salvador Poveda Toscar Crianza Tinto 2005 (€ 4.95), and Sartori Regolo Rosso Veronese IGT 2008 (€ 9.95). The right-hand sidebar contains a 'Login' section, 'Ihre Vorteile' (Benefits) such as 'Riesige Auswahl' and 'Günstige Preise', and 'Zahlarten - payments' (Payment methods) including 'Vorkasse - prepayment', 'Rechnung - invoice', and 'Lastschrift - direct debit'. It also features logos for 'PayPal' and other payment options.

for instance, baby boomers or music lovers—and then select a picture and slogan for an online banner ad. They also learn to boost the impact of their ads through proper placement; for example, they might arrange to have their ads appear on the Facebook pages of Pink Floyd fans or people born between 1945 and 1964.

Improving search-engine marketing. For this task, participants might be asked to write a Google text ad for the “Wines that Rock” collection. Since these ads are short—generally 20 words or fewer—participants must create succinct but compelling messages that incorporate keywords and follow other best practices such as highlighting discounts and product features that

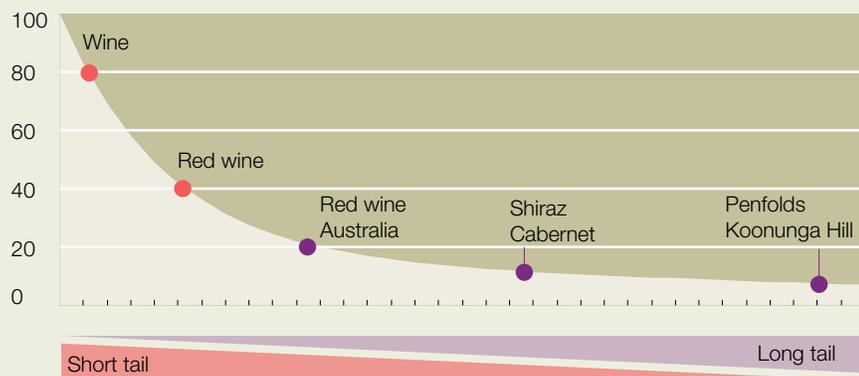
provide differentiation from competitors. Another part of the task is to select keywords that will prompt the ad to appear on Google’s results page and decide how much to pay for each click. Many participants initially select generic words or phrases such as “red wine,” which generate many clicks but few sales. DMF instructors teach them to favor more specific search terms, such as “Shiraz Cabernet.” While fewer consumers type in such phrases, those consumers are more likely to make a purchase than people who search for more general terms. In fact, our analysis showed that 80 specific phrases (such as “Penfolds Koonunga Hill”) delivered the same number of new customers as “wine” but at 2 percent of the marketing cost (Exhibit 2).

Exhibit 2

Companies benefit from the long tail when choosing keywords.

Search volume of different keywords on Google

Indexed to 100



Clicks per day	~940	→	~1.5
Cost per click, €	~4.1	→	~0.67
Conversion	<1%	→	8%
Cost per order, €	410	→	8.40

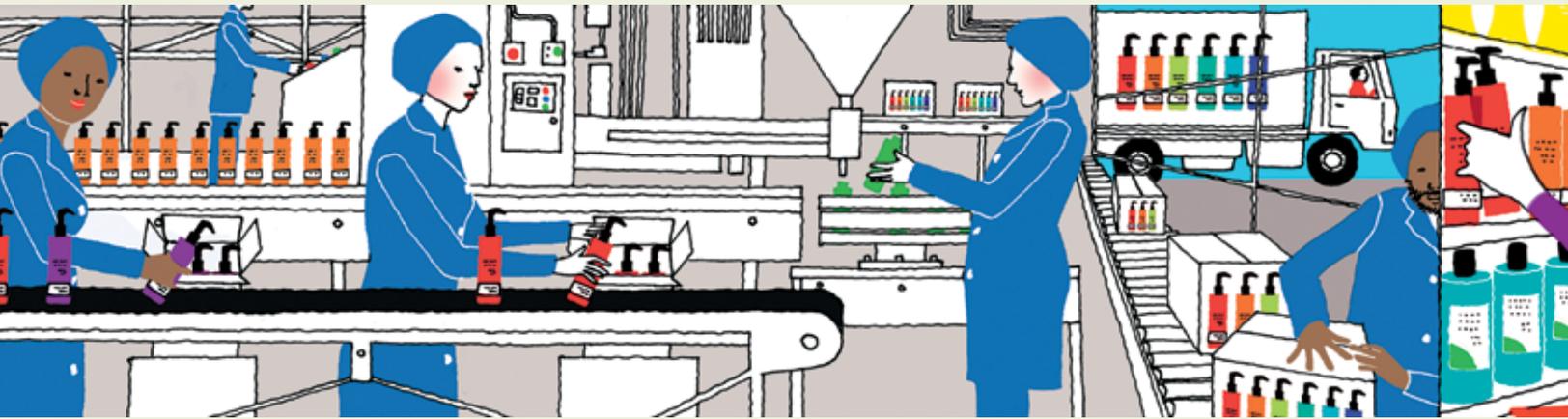
Source: BVDW; Google; Phaydon; McKinsey analysis

Using social media effectively. During this exercise, DMF instructors may ask participants to imagine that they must respond to a disparaging claim about Vinoya that is generating negative comments online. Trainees post a response on a Vinoya Facebook page open only to DMF participants. They then discuss whether their own companies are prepared to respond to similar criticism. Do they have a tool for monitoring online chatter? Could they respond rapidly, before a remark goes viral? Do they have a social-media manager who can direct overall efforts and take the lead when problems arise? And because social media can play an important role across the entire value chain, DMF training features case examples and best practices related not only to marketing

and sales, but also to product development and customer service.



Although its original focus was display advertising, search-engine marketing, and social media, the DMF—in response to demand—recently introduced new courses on a variety of topics, including digital sales and customer-life-cycle management, affiliate marketing, Web analytics, and mobile marketing. The goal of each session is to equip participants with practical digital-marketing skills that they can apply as soon as they return to the office. ○



Consumer-value operations: An integrated approach to operational excellence

Best-practice consumer-goods companies are focusing on commercial outcomes, enhancing their capabilities in all operations functions, and exploiting opportunities at the intersections of these functions.

**Soren Fritzen,
Deepak Mishra, and
Frank Sanger**

Many executives in charge of operations at consumer-packaged-goods (CPG) companies strive to deliver value within isolated functions. For example, heads of manufacturing try to rationalize overcapacity in plant networks, procurement officers consolidate their purchasing to leverage scale, and supply-chain executives seek to centralize their scattered supply-chain organizations.

Such piecemeal efforts, however, won't make much difference unless they're part of a broader operational-improvement effort. Europe's CPG companies are battling a multitude of challenges. Growth is slow to flat in most Western European markets. Commodity inflation and volatility are at

an all-time high. Retailers, in light of slow growth and the success of discount formats, are exerting pressure on pricing and promotions and demanding more custom SKUs—not only making it hard for manufacturers to pass on higher input costs but also driving up complexity costs. And although emerging markets in Eastern Europe continue to show tremendous growth potential, competing profitably requires investing in anticipation of growth—a tall order in an era of profit warnings and budget cuts.

Against this backdrop, isolated operational improvements will have limited impact—and may even be detrimental. Because operations functions are highly interconnected, any move to



Keiko Morimoto

optimize one function independently can undermine another function's performance. A drive to achieve lowest-cost material supply, for example, can at times increase manufacturing and downstream costs.

A big part of the answer for CPG companies lies in what we call “consumer-value operations”—an end-to-end approach to operations that is guided primarily by the consumer perspective and takes into account which products and activities truly drive commercial advantage. Best-practice CPG companies are basing their operations agenda on commercial outcomes, not just “four walls” operations performance. Examples of these outcomes, to which operations can make big contributions, include increasing customer satisfaction to drive share growth, delivering more new products faster, and competing cost-effectively against private labels.

To deliver such outcomes, leaders are managing operations levers holistically (exhibit). Rather than cherry-picking among functional areas or pursuing a “sum of its parts” operations program with disconnected initiatives, they are striving for excellence in all core functions. They are also working much more closely than before with the nominally commercial functions—marketing, sales, and research and development—to exploit opportunities at the intersections of the functional areas. In this article, we outline the elements of consumer-value operations and offer perspectives on how companies can begin to benefit from it.

Excellence in core competencies

Operational excellence requires top performance in five distinct competencies, in addition to the “table stakes” of achieving an adequate performance level in areas such as

quality, safety, service, and environmental compliance.

Segmented supply chain and planning

The idea of segmenting the supply chain—to serve each customer the right way, instead of serving all customers the same way—isn't new, yet only a few CPG companies have fully implemented it. A company could, for instance, prioritize customers based on profitability and strategic importance, and segment products based on volume and demand variability. This segmentation results in distinct “value streams,” or combinations of customers and products that should be measured and managed in an integrated way.¹ By segmenting its supply system into value streams, one CPG company reduced inventory by 20 to 30 percent and total costs by 6 percent, while significantly improving on-shelf availability at retail stores.

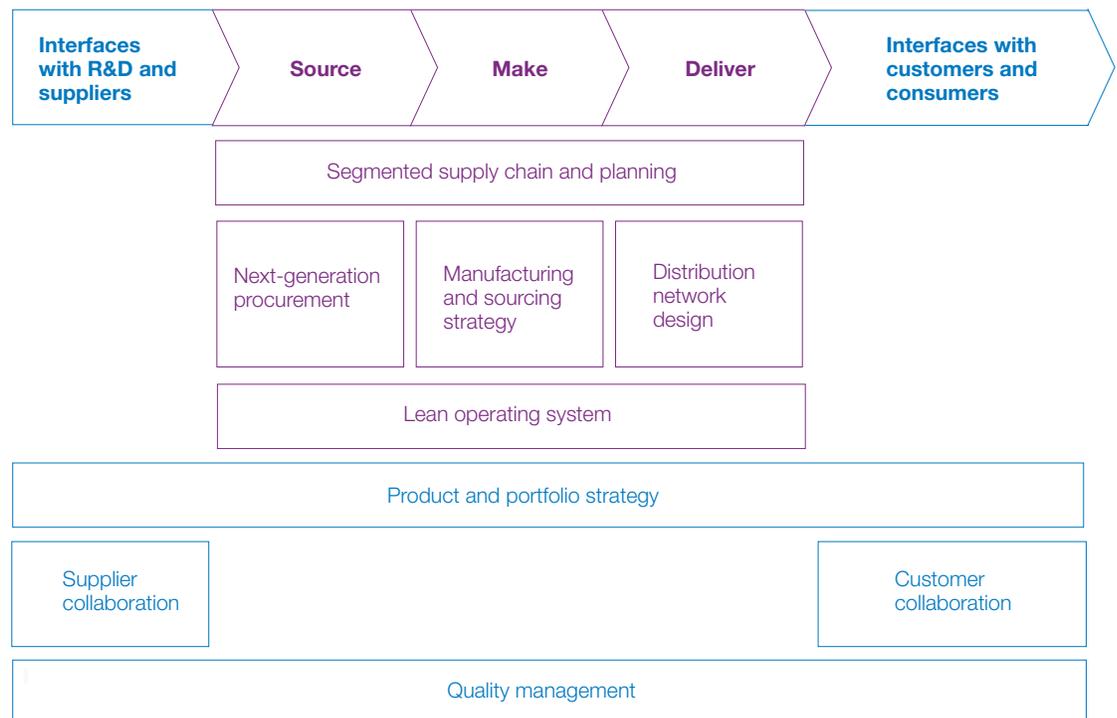
Next-generation procurement

Most CPG companies are already building procurement scale, consolidating suppliers, and developing centralized procurement functions. But to offset the volatile commodity environment, leading companies are making more assertive moves. They're pursuing more opportunities to capture scale benefits, such as by joining buying consortia for indirect procurement. They're developing commodity strategies based on distinctive knowledge of upstream supply economics and “clean sheet” or “should cost” models. And they're building risk-management capabilities to mitigate ongoing volatility. By taking these steps, best-in-class companies realize more than 10 percent reductions in direct spend and more than 15 percent reductions in indirect spend, with 80 percent of these improvements achievable in the first two years.

¹See Yogesh Malik, Alex Niemeyer, and Brian Ruwadi, “Building the supply chain of the future,” *mckinseyquarterly.com*, January 2011.

Exhibit

Leading CPG companies strive for excellence in the core functions and at the intersections between functions.



Manufacturing and sourcing strategy

Leading CPG companies distinguish between highly efficient “volume” and highly agile “innovation” factories or lines within their manufacturing networks, and manage them with different metrics. They use contract manufacturing in a deliberate way—not so much to manage the balance sheet but rather to provide flexible low-cost capacity or technology expertise not available in-house. They take a long-term view of network investments and build the capabilities needed to refresh their strategies when market and input costs shift. Well-designed networks typically result in 10 to 20 percent lower conversion costs and increased flexibility and

responsiveness. In addition, strict business-case requirements, careful design optimization, and sophisticated project-management approaches can deliver capital-expenditure savings of 20 to 30 percent and improve return on invested capital by as much as 4 percent.

Distribution-network design

Given soaring transport costs, CPG companies can’t afford to ignore inefficiencies in their logistics operations. A company should design its network based on precise knowledge of what customers need and which activities add value. In Western Europe, for example, our analysis shows that 14 to 18 strategically located distribution

centers (DCs) can make overnight deliveries to most large retail stores, 9 are sufficient for deliveries within 24 hours, and 6 can handle two-day deliveries. Concentrating inventories in fewer DCs leads to inventory savings; on the other hand, centralization increases transport costs due to longer distances and underutilized capacity. To correctly measure the inverse cost effects, companies must build a sophisticated model that covers all relevant factors. In our experience, companies can typically reduce logistics costs by up to 10 percent while maintaining or even raising service levels.

Lean operating system

Leading CPG companies are not only reinvigorating their lean programs in the manufacturing environment—typically achieving 15 to 25 percent reductions in conversion costs as well as improvements in capacity, flexibility, and responsiveness—but also applying lean philosophies across the entire value chain. A CPG company, for example, undertook a three-year lean transformation that started in one manufacturing plant in one business unit, then expanded to other locations, business units, and processes in a carefully sequenced rollout. The

company subsequently introduced lean techniques in planning, procurement, and transportation and warehousing.

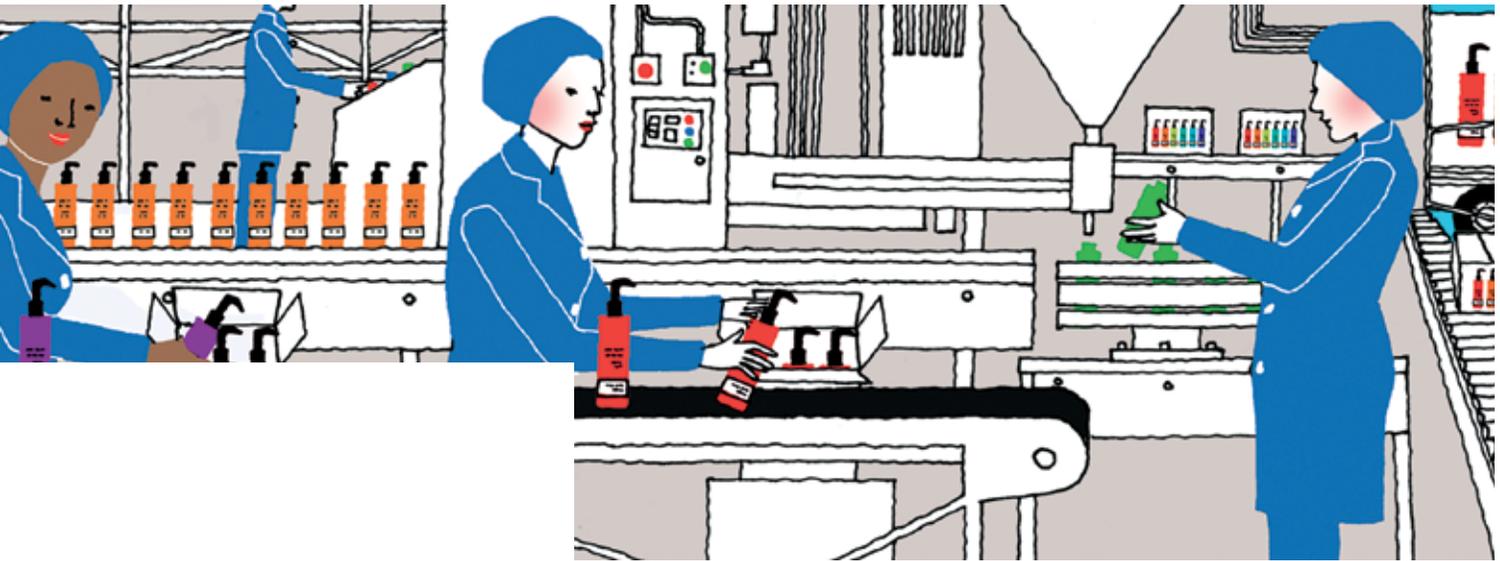
Winning at the intersections

The most successful companies don't make trade-offs among functional competencies. Instead, they aspire to best-in-class performance across—and at the intersections of—all functions, as well as in their interactions with suppliers and customers. They develop and execute operations strategies in close cooperation with the R&D and commercial functions. We see four intersections between functions, and between a company and its customers and suppliers, where improvement initiatives can deliver outsize rewards.

Product and portfolio strategy

CPG companies face the conflicting priorities of speeding more new products to market on the one hand, and improving gross margins and reducing portfolio complexity on the other. Leading companies break through the inherent trade-offs by developing three institutional capabilities: assortment optimization, “design to value” (DTV), and complexity management.





Assortment optimization consists of defining the ideal assortment from a consumer perspective. Leading companies assemble an assortment that covers all consumption occasions and consumer needs without duplication, methodically dropping non-value-adding SKUs that don't serve a strategic purpose and rigorously filling relevant gaps.

Leading companies also apply a cross-functional *DTV* approach to all new and existing products, designing and redesigning products to deliver greater consumer and customer value while lowering cost of goods sold (COGS) by as much as 200 to 300 basis points. They optimize specifications, recipes, and packaging designs

based on both consumer research and a detailed understanding of competitive products' cost structures.²

Finally, leading CPG companies excel in *complexity management*, having moved from sporadic SKU-rationalization exercises to a structured product-platforming approach similar to the automotive industry's. They harmonize products and specifications to create a small number of platforms (recipes, material standards, and packaging formats) based on consumer preferences, optimal assortments, manufacturing efficiencies, and other COGS drivers.³ They drive these platforms aggressively throughout the portfolio and set up their supply chain for

²See Ananth Narayanan, Asutosh Padhi, and Jim Williams, "Designing products for value," *mckinseyquarterly.com*, October 2012.

³See Jim Brennan, Philip Christiani, Frank Sanger, and David Spiller, "When less is more: How to manage portfolio complexity in consumer goods," *csi.mckinsey.com*, January 2011.

late-stage differentiation to enable faster launch times and multimarket launches.

Supplier collaboration

In an industry where supplier-related costs account for approximately 70 percent of COGS, more CPG companies are realizing the need to go above and beyond standard procurement practices. Sophisticated supplier collaboration and development efforts enable companies to create value through reduced packaging, ingredient, and processing costs; greater innovation; and meaningful improvements in quality, service, and sustainability.

A leading food-and-beverage manufacturer used a clean-sheet-based negotiation approach—comparing its current suppliers' costs to best-case scenarios achieved by the most efficient companies—to identify areas in which its packaging suppliers could substantially reduce costs through leaner production methods. It worked with its suppliers to set production-improvement targets, established joint teams to optimize material specifications, and improved data sharing for timelier and more accurate forecasts. Combined, these efforts delivered

15 to 25 percent reductions in packaging-material costs.

Customer integration and collaboration

Collaboration efforts between manufacturers and retailers have proliferated in recent years. Many CPG companies, for example, are partnering with retailers to tailor the supply chain and planning approach for new products. Successful retailer collaboration is neither quick nor simple, but the effort pays off. Deeper supply-chain collaboration—on optimizing processes, sharing data, and building logistics networks—delivers a return equivalent to a profit uplift of 4 to 6 percent through a combination of increased sales from better on-shelf availability and reduced costs.

Quality management

Quality costs—both direct (such as warranties and replacements) and indirect (including rework and scrap)—are an often-overlooked pool of costs that can be turned into ready cash in the short term and profit-improvement opportunities in the medium term. A comprehensive quality-improvement program can not only reduce quality costs by 10 to 15

Best-practice companies develop a clear understanding of consumers' quality expectations and perceptions.

One CPG company's experience

A global CPG company launched an operations transformation program that focused initially on manufacturing and procurement—the areas in which the company initially perceived the greatest opportunities. But strong transformation results in those areas, along with broader business pressures, compelled the leadership team to expand the scope of the transformation to cross-functional topics such as supply-chain and portfolio management.

Given the scope of change, the company adhered to two guiding principles. The first was to start small, prove the solution, and then deploy. For example, when the company designed new production-planning and scheduling processes and tools, it first piloted them in one country

before rolling them out more broadly. The second guiding principle was to focus on capability building: the company matched capabilities to the initiatives and built capabilities to fill any gaps. It sequenced the implementation of initiatives in waves, employing “train the trainer” approaches and establishing stringent performance metrics and structured performance dialogues. It also built a team of internal continuous-improvement experts to drive higher and more sustainable impact and to encourage widespread changes in mind-sets and behaviors.

The results included 300 to 400 basis points margin improvement, 20 to 30 percent cash savings, and increased operations capabilities.

percent but also spur sales increases of as much as 5 percent due to greater customer demand for the new, higher-quality products.

Best-practice companies first develop a clear understanding of consumers' quality expectations and perceptions—for example, through consumer surveys, third-party rating systems, analysis of social-media mentions, and focus groups. They ensure that their quality strategy and targets reflect these expectations when it comes to the product concept, the product itself (for example, its trustworthiness or health benefits), and the shopping and service experiences. They then translate these quality targets into metrics and key performance indicators (KPIs) for each functional department. One KPI for a manufacturing plant might be the number of

customer complaints per million units; a KPI for a distribution center might be the rate of “perfect” (on-time and accurate) deliveries.

Executing a holistic operations strategy

Companies intent on implementing consumer-value operations understand that it requires a multiyear transformation. They set high aspirations and dedicate their best people to lead the change (see sidebar, “One CPG company's experience”). And they make deliberate choices about their operating model and IT, both of which are critical to success.

Many CPG companies have moved from country-specific to regional—or, in some cases, global—operating models to capture economies of scale and deploy more highly skilled talent. However, in

so doing they limit their flexibility to meet local demand requirements, which is essential to support growth in emerging markets. Companies that strike the right balance between operating-model centralization and flexibility make choices based on business characteristics, differentiating as needed among markets.⁴ They ensure alignment between the operating model and the commercial model by instituting cross-functional processes with joint accountability, especially with respect to sales and operations planning, financial planning, new-product introduction, capital-expenditure strategy, and product-portfolio management.

IT is another crucial enabler of consumer-value operations. Most CPG companies make major investments in enterprise-resource-planning and supply-chain-management systems to support the analytics, integrated information flows, and data harmonization required to deliver on operations transformation. But such systems won't automatically yield results. To capture the anticipated value through IT capabilities, leaders must define their operations strategy, operating model, and sources of value up front, and then

tailor their IT solutions accordingly. They must establish governance bodies encompassing IT as well as business units, and these governance bodies should determine IT-enablement priorities, firmly rejecting IT-related requests that don't align with the strategy. They must also develop a business-driven (not IT-driven) road map that delivers quick wins while ensuring that personnel are trained in new ways of working.



A transformational operations effort can begin with an objective, fact-based maturity assessment, in which the company compares its current processes to best practices in each element of consumer-value operations. This assessment should include an analysis of key gaps and potential roadblocks, as well as a quantification of the opportunity. Such an exercise—if it takes into account the perspectives of stakeholders across functions and regions—can energize and motivate the entire organization, making it an important first step in the journey toward operational excellence. ○

⁴See Martin Dewhurst, Jonathan Harris, and Suzanne Heywood, "The global company's challenge," *mckinseyquarterly.com*, June 2012.



The \$30 trillion decathlon: How consumer companies can win in emerging markets

By 2025, annual consumption in emerging markets will reach \$30 trillion. Companies must master ten key disciplines—or miss the defining growth opportunity of our time.

**Yuval Atsmon,
Peter Child, and
Udo Kopka**

CEOs at most large multinational companies say they recognize the importance of the rise of middle-class consumers in emerging markets. Yet those same executives are vexed by the complexity of this opportunity. In 2010, 100 of the world's largest companies headquartered in developed economies derived just 17 percent of their total revenue from emerging markets—even though those markets accounted for 36 percent of global GDP and are likely to contribute more than 70 percent of global GDP growth between now and 2025. Western European companies fared slightly better than their North American counterparts: the 39 Western European companies among the 100 largest advanced-economy companies earned 25 percent of revenues from emerging markets

compared with just 10 percent for the 37 North American companies. But the companies in both regions fail to come close to realizing the full potential of the emerging-market opportunity.

Our experience suggests that the challenge in emerging markets resembles a decathlon, where success comes from all-around excellence in multiple sports. Sitting out an event isn't an option; competing effectively means mastering a variety of capabilities. In emerging markets, companies, like athletes, must learn to make trade-offs, taking into account their own capabilities and those of competitors. The rewards for success and the costs of failure will be large.



Keiko Morimoto

The \$30 trillion opportunity

Over the past two decades, the number of people earning more than \$10 a day¹—roughly the level at which households can contemplate discretionary purchases of products such as refrigerators and TVs—has more than doubled, to 2.4 billion people. McKinsey Global Institute (MGI) research suggests that by 2025 that number will nearly double again, to 4.2 billion consumers.²

The overwhelming majority of these new consumers will hail from emerging markets. MGI estimates that by 2025 annual consumption in emerging markets will rise to \$30 trillion and account for nearly 50 percent of the world's total (Exhibit 1).³ Even under the most pessimistic scenarios for global growth, emerging markets are likely to outperform developed economies significantly for decades.

Leading the way is a generation of consumers in their 20s and early 30s who are confident their incomes will rise and are willing to spend in order to realize their high aspirations. These new consumers have come of age in the digital era. Already, more than half of all Internet users globally are in emerging markets. Emerging consumers are shaping the digital revolution, not just participating in it, and they are leapfrogging developed-market norms.

Companies failing to pursue these consumers will squander opportunities to build positions of strength that, history suggests, could be long lasting: in 17 major product categories in the United States, the market leader in 1925 remained the number-one or number-two player for the rest of the century.⁴

Ten crucial capabilities

For developed-market companies, winning in these high-growth markets requires radical

changes in mind-sets, capabilities, and resource allocation. With the help of colleagues, we've distilled a set of ten capabilities global corporations need in emerging markets. Just as winning a decathlon requires an athlete to master ten events, winning in emerging markets requires companies to master the following ten capabilities.

1. Surgically target urban growth clusters

The scale of the modern exodus from farms to urban areas has no precedent. The population of cities in developing economies grows by at least 65 million a year—the equivalent of seven cities the size of Chicago. Over the next 15 years, just 440 emerging-market cities will generate nearly half of global GDP growth.

Midsized cities frequently offer the best opportunities. In Brazil, for instance, competition in the metropolitan market of São Paulo is brutal and retail margins are razor thin. New entrants to the Brazilian market might find better options in the northeast, Brazil's populous but historically poorest region, where boomtowns like Parauapebas are growing by as much as 20 percent a year.

The notion that smaller cities can offer bigger opportunities isn't new. Fifty years ago, Wal-Mart opened its first store in Rogers, Arkansas, and proceeded to build one of the world's largest businesses by avoiding highly competitive metropolitan markets. Many multinationals nonetheless assume that developing local strategies for "middleweight" cities can come only at the expense of economies of scale. To minimize that trade-off, global companies should group smaller cities into clusters with common demographics, income distributions, cultural characteristics, media markets, and transportation links. Exhibit 2 shows urban

¹On a purchasing-power-parity basis.

²Richard Dobbs, James Manyika, Jaana Remes, Charles Roxburgh, Fabian Schaer, and Sven Smit, *Urban World: Cities and the Rise of the Consuming Class*, McKinsey Global Institute, June 2012.

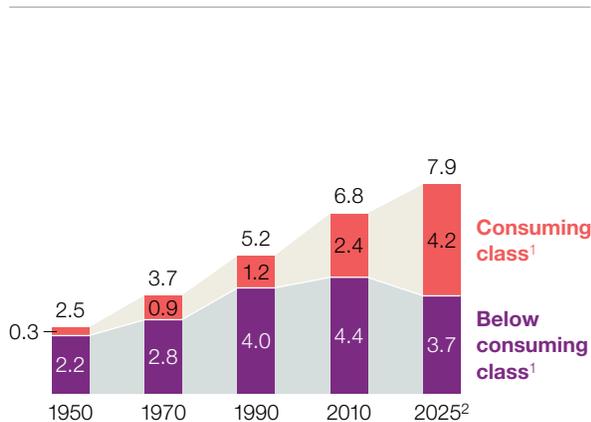
³The estimate of \$30 trillion reflects private consumption in emerging-market regions in 2025. The regions included are Africa, Central Asia, China (with Hong Kong and Taiwan), Eastern Europe, Latin America, the Middle East, and South and Southeast Asia. Emerging-market consumption in 2025 is estimated by applying the private-consumption share of GDP per country to national GDP estimates for 2025, calculated on the basis of consensus GDP growth projections from the Economist Intelligence Unit, Global Insight, Oxford Economics, and McKinsey's long-term growth model. This approach implicitly assumes that private consumption as a share of GDP will remain constant through 2025. Past evidence from developed economies suggests the share of private consumption in many countries will increase with income, which would lead to a higher projected level of emerging-market consumption in 2025.

⁴These companies include Del Monte Foods, which led in canned fruit; Nabisco, which led in biscuits; and Wrigley, which led in chewing gum.

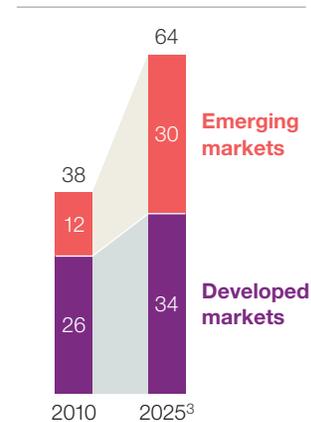
Exhibit 1

By 2025, the consuming class will swell to 4.2 billion people. Consumption in emerging markets will account for \$30 trillion—nearly half of the global total.

World population, billions



World consumption, \$ trillion



¹Consuming class: daily disposable income is \geq \$10; below consuming class, $<$ \$10; incomes adjusted for purchasing-power parity.

²Projected.

³Estimate based on 2010 private-consumption share of GDP per country and GDP estimates for 2010 and 2025; assumes private consumption's share of GDP will remain constant.

Source: Angus Maddison, founder of Groningen Growth and Development Centre, University of Groningen; Homi Kharas, senior fellow at Wolfensohn Center for Development at Brookings Institution; McKinsey Global Institute analysis

clusters in China. By running operations through a common management hub and pursuing gradual, cluster-by-cluster expansion, companies can gain scale efficiencies in all aspects of their operations, including marketing, logistics, supply-chain management, and distribution. For all but a handful of high-end product and service categories, the emphasis should be on “going deep” before “going wide.”

2. Anticipate moments of explosive growth

In emerging markets, timing matters as much as geography in choosing where to compete. Demand for a particular product or category of products typically follows an S-curve: there is a “warm-up zone” as growth gathers steam and consumer

incomes rise, a “hot zone” where consumers have enough money to buy a product, and a “chill-out zone” in which demand eases (Exhibit 3).

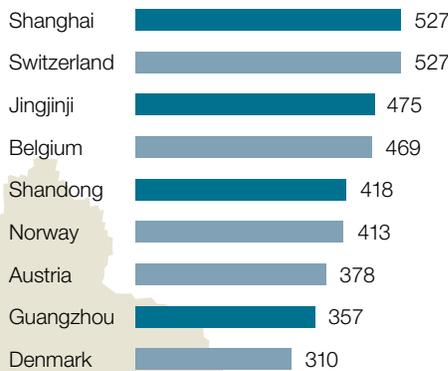
In plotting consumption S-curves, per capita income is the critical variable. But the takeoff point and shape of consumption curves varies by product or service. Purchases of products with low unit costs, such as snacks and bottled drinks, accelerate at a relatively early stage of the income curve, beauty products somewhat later, and luxury products later still.

Refrigerators tend to have a steep adoption curve that flattens out as the market reaches saturation, while spending on clothing displays a more sustained growth pattern.

Exhibit 2

A clustering approach can help companies target consumers more effectively in Chinese cities, some of which are economically larger than entire European countries.

2010 GDP for urban clusters in China vs selected countries, \$ billion



Urban clusters in China and their hub cities

Clusters are grouped by size, based on average 2015 urban GDP estimates

● Small ● Large ● Mega

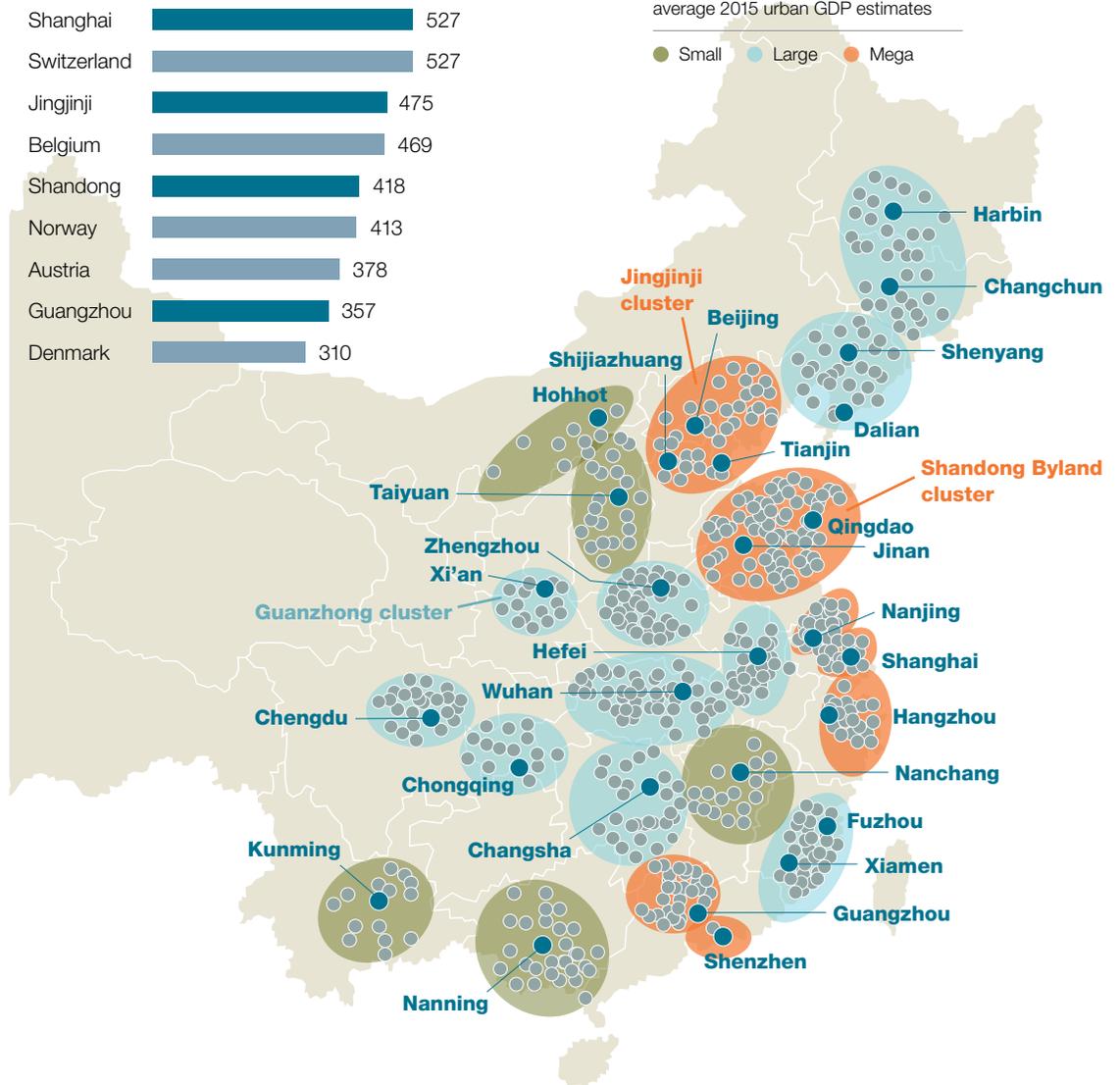
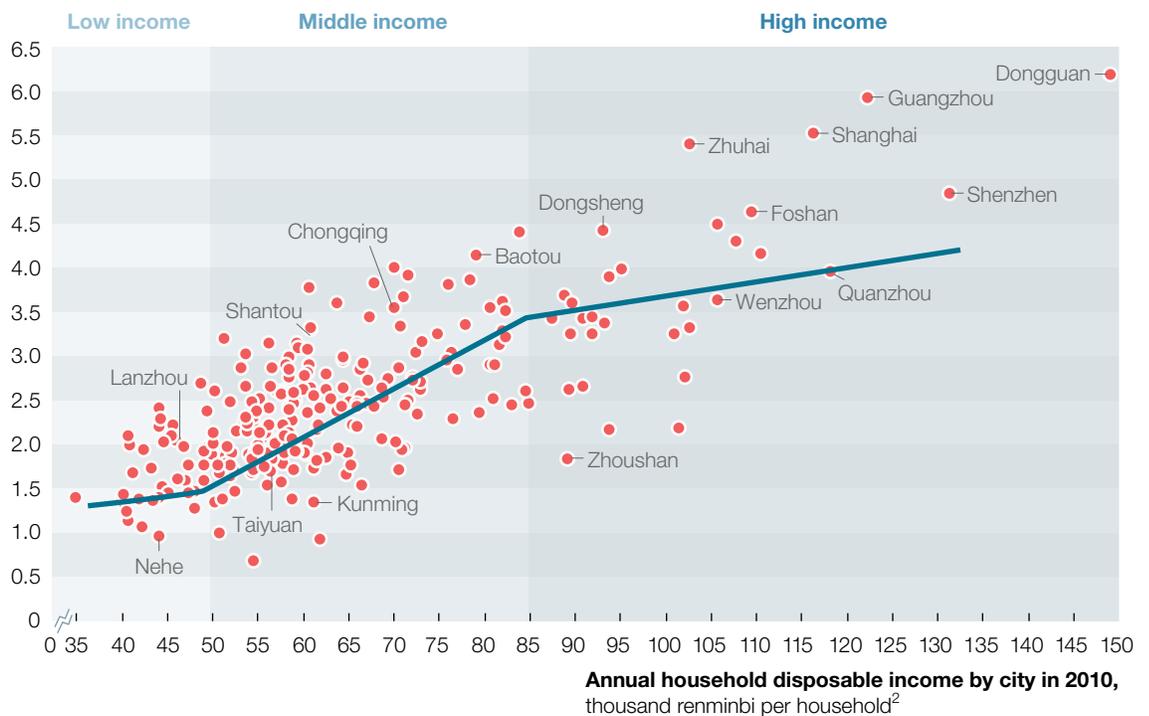


Exhibit 3

In China, consumption of household products takes off at middle-income levels, following an S-curve.

Annual consumption of household products¹ by city in 2010,
thousand renminbi per household²



¹Includes white goods, furniture, and home accessories.

²In 2010 real renminbi; 6.77 renminbi = \$1 in 2010.

Source: National Bureau of Statistics of China; McKinsey analysis

Adoption patterns of products within the same general category can vary widely, too. For example, in Beijing, purchases of refrigerators start to take off at annual incomes of \$2,500 a year but slow above \$6,000, while the acceleration for washing machines doesn't begin until incomes approach \$10,000.

Predicting when and where consumers will move into the hot zone requires a granular

understanding of technological, demographic, cultural, geographic, and regulatory trends, as well as a thorough knowledge of local distribution networks. Because many of India's households are vegetarian, for example, meat consumption there is much lower than the global average. In China, rising incomes, greater awareness of the benefits of baby formula, and concerns about the safety of low-end brands have helped make baby food the fastest-growing

product category in the supermarket sector. Between 2000 and 2010, annual sales of baby formula in China soared from RMB 6 billion to RMB 36 billion, despite the number of births remaining stagnant at 16 million a year.

3. Devise segmentation strategies for local relevance and global scale

Multinationals must refine product or service offerings to appeal to (or even shape) local tastes, be affordable, and allow the company to achieve reasonable scale quickly. Too often, multinationals paint emerging-market consumers as caricatures: at one extreme is the nouveau riche, eager to flaunt its wealth and emulate the West; at the other is the penny-pinching poor, for whom the overriding purchase criterion is getting the lowest price. With the number of mainstream consumers on the rise in emerging markets—more than half of all Chinese urban households, for example, will be solidly middle class by 2020, up from 6 percent in 2010—companies are learning to craft more nuanced product strategies.⁵

A careful segmentation strategy helped Frito-Lay capture more than 40 percent of the branded-snacks market in India. The company tailored global products, such as Lay's and Cheetos, to local tastes. Frito-Lay also created Kurkure, a cross between traditional Indian street food and Western-style potato chips. Kurkure established a new category in India and is now being sold in other countries. Attractive pricing and local feel, combined with scalable international packaging, were critical to Kurkure's success.

Leading companies also look for opportunities to scale ideas across emerging markets. Unilever, for example, markets its Pureit water filter, first launched in India in 2005, to consumers in Asia, Eastern Europe, and South Africa.

4. Radically redeploy resources for the long term

Our research shows that emerging-market companies redeploy investment across business units at much higher rates than their developed-market counterparts and are growing faster than them, even in neutral markets where neither is based. Emerging players' growth advantage persists even after controlling for the smaller base from which they start, and it also exists in developed markets.⁶

In part, the agility of emerging-market companies reflects the fact that they don't have to straddle the rich and developing worlds. By contrast, CEOs at multinationals must protect their flank at home as they pursue emerging markets that carry significant near-term risks. The investment profile of global consumer-products giants with a successful presence in emerging markets indicates an interval of approximately four to five years until investments pay off. M&A can accelerate progress. Consider Danone's purchase in Russia of Unimilk, which allowed the French food giant to offer products at a wider variety of prices. Similarly, Diageo's acquisition of a majority stake in China's Shui Jing Fang boosted the British beverage company's distribution reach.

5. Innovate to deliver value across the price spectrum

Emerging markets offer opportunities to design products and services with innovative local twists. South Korea's LG Electronics, for instance, struggled in India until the 1990s, when a change in foreign-investment rules enabled the company to invest in local design and manufacturing facilities. Local employees, recognizing that many Indians use their TVs to listen to music, urged LG to introduce new models with better speakers. To keep prices competitive, the company swapped flat-panel displays for less costly cathode-ray tubes.

⁵We define mainstream consumers in China as members of relatively well-to-do households, with annual disposable incomes of \$16,000 to \$34,000. For more on China's mainstream consumers, see Yuval Atsmon and Max Magni, "Meet the Chinese consumer of 2020," mckinseyquarterly.com, March 2012.

⁶For example, in emerging economies where both categories of companies are off their home turf, the growth advantage for emerging-market companies is 18.1 percent. In neutral developed markets, the advantage is 10.7 percent. The smaller size of emerging-market businesses accounts for, on average, no more than a quarter of the overall growth differential. For more on this research, see Sumit Dora, Sven Smit, and Patrick Viguerie, "Drawing a new road map for growth," mckinseyquarterly.com, April 2011 and Yuval Atsmon, Michael Kloss, and Sven Smit, "Parsing the growth advantage of emerging-market companies," mckinseyquarterly.com, May 2012.

Today, LG markets many other original products in India, such as microwaves with one-touch “Indian menu” functions. LG’s product-innovation center in Bangalore is its largest outside South Korea, and the company is India’s market leader in air conditioners, refrigerators, TVs, and washing machines. Others have followed LG’s lead and opened research facilities in emerging markets: between 1999 and 2008, the number of multinational companies with major research centers in China rose to approximately 1,000, from fewer than 40.

Local players too are proving nimble innovators. For rural customers, China’s Haier makes extra-durable washing machines that can wash vegetables as well as clothes, and refrigerators with protective metal plates and bite-proof wiring to guard against mice. Dabur, an Indian consumer-health company, combines Western science with Indian Ayurvedic medicine to offer innovative products in India and many other markets. Tanishq, part of the Tata Group, has built a fast-growing jewelry business with localized design and payment options that cater to different Indian communities and regions.

[6. Build brands that resonate and inspire trust](#)

On average, emerging-market consumers are younger, with 63 percent aged 35 or under in 2010, versus 43 percent in developed countries. And they are highly receptive to branding efforts but also far more likely than developed-market consumers to dump one brand for the next new thing.

These characteristics have significant implications for brand and marketing strategies. In emerging markets, it is critical for products to be included in consumers’ initial consideration sets (the short list of brands they might purchase). Chinese consumers initially consider an average of three

brands and end up purchasing one of them about 60 percent of the time, whereas consumers in the United States and Europe initially consider at least four brands and select one of them only 30 to 40 percent of the time. Emerging consumers’ focus on the initial consideration set favors brands with high visibility and an aura of trust. Multinationals can build visibility with a cluster-by-cluster strategy that achieves top-of-mind recognition in a handful of selected cities before moving to the next batch. Locally focused campaigns also make it easier to generate positive word-of-mouth. McKinsey surveys find that product recommendations from friends or family are twice as important for consumers in China and nearly three times as important for consumers in Egypt as for those in the United States and Britain.

Mobile and digital channels offer additional opportunities to build trust and brand awareness. Surveys indicate Chinese consumers are more likely to trust online recommendations than TV advertisements. Brazilians are among the world’s most enthusiastic tweeters; by 2010, a quarter of Internet users in Brazil had opened Twitter accounts. In India, consumers are embracing mobile devices, while low literacy rates are spurring the development of voice-activated Web sites and services.

In Beijing in 2011, the global condom brand Durex discovered the Web’s extraordinary potential. During a rainstorm, a Durex social-media marketer stretched condoms over his sneakers to keep them dry. Colleagues posted photos online with the caption, “Crazy rain! Luckily I had a couple of Durex!” The post went viral, reaching 80,000 people in its first 24 hours and generating coverage in the mainstream press. At virtually no cost, the post raised brand

awareness and created a witty and irreverent brand image for Durex.⁷

7. Shape the route to market

Our research underscores the importance of the in-store experience. In China, 45 percent of consumers make purchasing decisions inside shops, compared with 24 percent in the United States. Almost a quarter of the Chinese consumers we surveyed said in-store promoters or salespeople greatly influence their decisions.

Managing the in-store experience is an enormous challenge, in part because of the fragmented retail landscape. China's 50 largest retailers have only a tenth of the market share of the 50 largest US retailers. Reaching small outlets often means negotiating bad roads and a byzantine, multitiered network of distributors and wholesalers. In these locations, local champions have clear advantages, including long-standing alliances with distributors and armies of low-paid salespeople. Multinationals should be prepared to build a much larger in-house sales operation in these countries than they have in their home markets. They should also devote far more time and energy to segmenting sales outlets and devising precise routines and checklists for monitoring the in-store experience.

In India, Unilever distributes directly to more than 1.5 million stores by deploying thousands of people for sales and in-store merchandising, many equipped with handheld devices. For priority outlets, a heavy-control model—using supervisors, “mystery shoppers,” and sophisticated IT support—is often essential. Coca-Cola, long active throughout the developing world, goes to great lengths to analyze the range of retail outlets, identify the highest-priority stores, and understand differences in service requirements by

outlet type. For each outlet type, Coca-Cola generates a “picture of success”—a detailed description of how its products should be displayed, promoted, and priced. In China, Coca-Cola sells directly to over 40 percent of its two million retail outlets and monitors execution in an additional 20 to 30 percent through regular visits by Coca-Cola salespeople and merchandisers. In Africa, Coca-Cola has built a network of 3,200 “microdistributors”—entrepreneurs who use pushcarts and bicycles to deliver products to hard-to-reach outlets.

Companies must also develop capabilities to serve online retailers or build their own online sales platforms. In China, online sales in many product categories are growing explosively. One of China's largest retailers, Suning, said it aims to boost online sales to 45 percent of total revenue by 2020, up from 7 percent today.

8. Organize today for the markets of tomorrow

As global companies grow bigger, the costs of coping with complexity rise sharply. Less than 40 percent of the executives at global companies surveyed recently by McKinsey's organization practice said they were better than local competitors at understanding the operating environment and customers' needs. Furthermore, adhering to standard policies and practices sometimes hinders managers of global companies in emerging markets from moving quickly to lock in early opportunities.

There's no definitive solution to these challenges, but some important principles are emerging.⁸ For example, we've found that multinationals can boost their effectiveness by focusing on a few key management processes for which global consistency is advantageous, while allowing variability in others. Grouping high-growth

⁷“Durex microblog in China—surprisingly [sic] success,” *Marketing* 555, January 26, 2012 (marketing555.wordpress.com).

⁸See Martin Dewhurst, Jonathan Harris, and Suzanne Heywood, “The global company's challenge,” *mckinseyquarterly.com*, June 2012.



countries together (even when not geographically proximate) might help top management assess their needs. Clarifying the role of the corporate center is critical; too often, headquarters assumes functions that add complexity but little value. New communications technologies can help, but management must ensure they do not ensnare employees in an ever-expanding web of teleconferences in disorienting time slots, with hazy agendas and ill-defined decision rights. The farther flung the organization, the greater the virtue of simplicity.

[9. Turbocharge the drive for emerging-market talent](#)

Unskilled workers may be plentiful in emerging societies, but skilled managers are scarce and hard to retain. Global companies must develop clear value propositions for talent—an employer brand, if you will—to differentiate themselves. In South Korea, L'Oréal established itself as a top choice for female sales and marketing talent by creating greater opportunities for brand

managers, improving working hours, expanding the child-care infrastructure, and adopting a more open communication style.

Deepening ties between corporate functions and emerging markets can create opportunities for local talent while enhancing organizational effectiveness. In 2010, about 200 managers from Unilever's Indian subsidiary were assigned global roles. At Yum Brands, the leader of the Indian organization reports to the global CEO.

Global companies need bold talent-development targets. We think many players should aspire to multiply the number of leaders in emerging markets tenfold—and to do that in one-tenth of the time they would take back home. In India, Reliance Group, one of the country's largest private employers, addressed a need for as many as 200 new functional leaders by recruiting a wave of 28- to 34-year-old managers and enlisting help from local business schools and management experts to design new development programs.

10. Lock in the support of key stakeholders

Successful businesses need the support of key stakeholders in government, civil society, and the local media (increasingly shaped by online commentators). We believe global companies must devote far more time and effort to building such support in emerging markets than they would in developed ones. Such efforts should include cultivating relationships with local business allies—customers, joint-venture partners, investors, and suppliers.

Amway's success in China illustrates the benefits of effective stakeholder management. In the early 2000s, the US-based direct-sales giant was almost declared an illegal business in China for violating a 1998 ban on direct selling. Amway's senior executives made numerous visits to Beijing to get to know senior leaders and explain the company's business model. It also demonstrated its commitment to China by opening stores countrywide and investing more than \$200 million in manufacturing and R&D centers in China. In 2006, the Chinese government reshaped the regulation of direct sales and Amway made

adjustments to its practices to comply with regulations. Today Amway is China's second-largest consumer-products business.



As senior leaders commit to priority emerging markets, they must reassure stakeholders that this commitment won't come at the expense of domestic performance. One thing that can help is developing clear metrics for tracking success in emerging markets—for example, year-on-year comparisons of market share in critical urban clusters—which can reveal any need for course corrections.

During the next 100 years, the companies looked to as the world's greatest will surely be those that win in emerging markets. Business leaders must make the changes required to win or risk being overtaken by competitors with bolder ambitions. ○



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Luxury lifestyle: Beyond the buzzwords

When luxury players expand into lifestyle offerings, they must be careful to avoid diluting their brand.

**Linda Dauriz and
Thomas Tochtermann**

Half a century ago, fashion designer Coco Chanel asserted that fashion transcends products. “Fashion is not something that exists in dresses only,” she said. “Fashion is in the sky, in the street. Fashion has to do with ideas, with the way we live.” Fashion, she suggested, is part of a lifestyle.

Fashion labels and luxury brands have long been interested in portraying themselves as purveyors and curators of a “luxury lifestyle.” Some luxury-apparel brands, for instance, have expanded their product offering to include lifestyle products and service lines such as housewares, furniture, fine dining, hotels, and apartments.

But they should tread carefully. In his remarks at the 2012 *Financial Times* Business of Luxury Summit, François-Henri Pinault, chairman and CEO of luxury giant PPR, raised the question of whether the concept of lifestyle adds value to the business of luxury or detracts from it. We believe lifestyle has the power to do either. Building credibility as a lifestyle brand takes time, and even those who have built credibility find that it is more easily lost than won.

In this article, we examine how luxury players can capitalize on the lifestyle potential of their brands—without diluting their heritage along the



Toko Ohmori

way. Our insights are based on recent research, including interviews with senior executives from more than 20 luxury-goods companies and in-person interviews with close to 100 consumers in four European countries, as well as our work with luxury-goods players worldwide.

What does lifestyle mean in luxury?

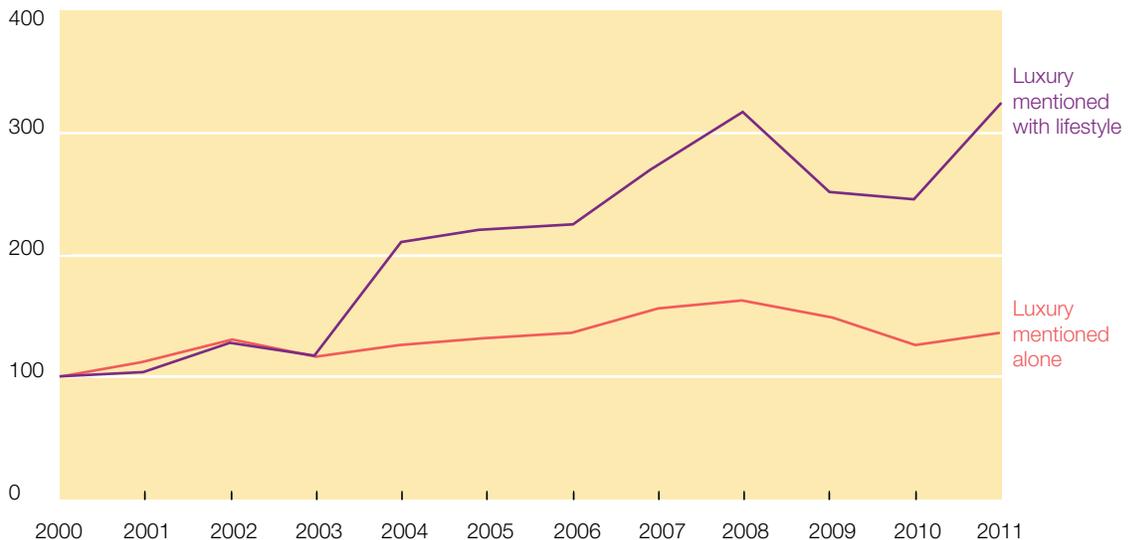
If we look at print media in the past decade, we find the words “luxury” and “lifestyle” appearing together more frequently than ever before (Exhibit 1). But despite the close association between these two concepts, our research indicates that there is no widely accepted definition of “luxury lifestyle.”

Attendees of the 2012 *Financial Times* Business of Luxury Summit suggested the following definitions: “a way of living,” a set of “attitudes and values,” or specific “consumption habits.” Consumers interviewed in London, Milan, Munich, and Paris gave equally diverse definitions. Some offered a broad perspective (“a way of being, dressing, behaving” that “sets you apart from the rest”); others referred to particular products, brands, and experiences (“staying at nice hotels”); still others took a cynical view (“it’s just brand names, that’s all” or “it’s marketing”). Our interviews with senior executives from luxury-goods companies such as Harry Winston, Hermès, and Roberto Cavalli yielded yet another varied set

Exhibit 1

The press increasingly perceives lifestyle as an element in luxury.

Index of number of articles,¹ 2000 = 100



¹The article sample is drawn from an analysis of 12 English-language publications, including newspapers such as the *New York Times* and *Wall Street Journal* and magazines such as *Advertising Age*, *Drapers*, and *Vogue*.

of definitions, including “embodying the lifestyle of an iconic designer” and “offering a holistic brand experience.” Although they all defined the phrase differently, 70 percent of the executives we interviewed said they regard their brands as luxury-lifestyle brands.

Lifestyle provides growth opportunities beyond the core

Many luxury brands have looked to lifestyle for growth opportunities. Through our research, we identified two dimensions in which brands have expanded into lifestyle: touch points and categories (Exhibit 2). The touch-points axis captures the degree to which a brand leverages lifestyle in the content, channels, and formats it

uses to engage with consumers—including TV commercials, point-of-sale materials, Web sites, and experiential offerings such as store events. The category axis shows the range of products, services, or types of experiences a brand offers beyond its original core.

Brands with low scores on the touch-points axis focus their communications on the product. Their print advertisements, for example, tend to show the product and perhaps a model, at most. These brands also tend to limit their marketing mix to traditional vehicles, such as print advertising and flagship stores, and rarely use digital communications or social-media platforms.

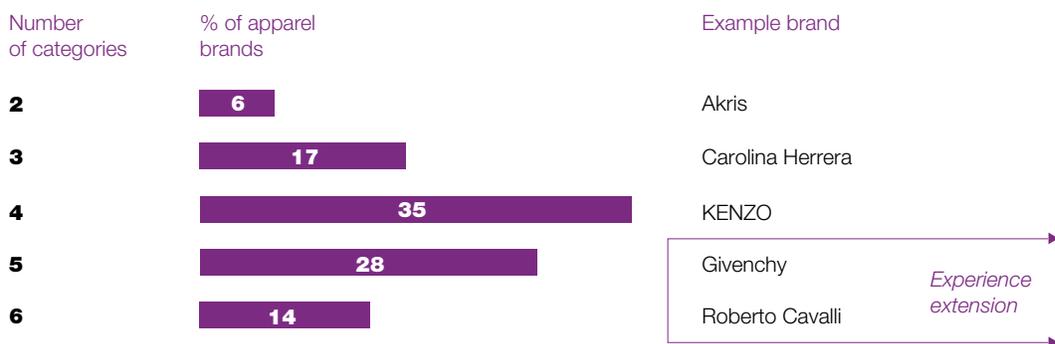
Exhibit 2

Several luxury brands already leverage lifestyle elements, both across touch points and in their offering.



Exhibit 3

Apparel brands have expanded into lifestyle products and experiences.



By contrast, brands that score high on this axis use imagery that extends well beyond the product; their campaigns feature cityscapes, leisure activities, and other scenes portraying a luxurious life, in which the product is not necessarily the focal point. One example is the Louis Vuitton “Core Values” ad campaign, photographed by Annie Leibovitz and featuring well-known personalities: Keith Richards in a hotel room with a Louis Vuitton custom guitar case by his side; Mikhail Gorbachev and his Louis Vuitton travel bag in the backseat of a car, driving by the Berlin Wall; Sean Connery with a deserted white-sand beach in the background, Louis Vuitton bag at his feet. In their attempts to become associated with a luxury lifestyle, luxury brands develop marketing campaigns that connote exploration, adventure, glamour, and celebrity. And they depict a luxury lifestyle consistently across multiple touch points, often including not only fashion magazines and videos but also blogs, social media, and mobile applications.

On the category-coverage axis, all the companies we examined have extended their business well beyond their original core. Thirty-five percent of brands that have their origins in apparel, for example, now offer an assortment that spans four categories (Exhibit 3). Some brands have even moved beyond the realm of products, adding experiences and hospitality services such as hotels, restaurants, or spas to their offering. Examples include Givenchy and Roberto Cavalli. Although hospitality services may generate only a fraction of an apparel maker’s total revenue, these ventures can make a meaningful contribution to the brand’s identity. Armani is among the most active apparel players in the hospitality arena, with more than a dozen cafés, two restaurants, and several hotels.

Climbing the lifestyle ladder

Exhibit 2 shows where a few brands stand on today’s luxury-lifestyle playing field. However, it tells us little about the path they followed to get to where they are. In studying the trajectories of

different brands—in particular, the sequence of their category-extension efforts—we identified two distinct patterns:

Luxury brands with their origins in apparel are the most prolific lifestyle players. Many of them expanded into fragrances in the 1980s and 1990s, then added jewelry, watches, and home products in the early 2000s. Within the last few years, several have entered the experience business. But each apparel player has taken a unique approach. The Carolina Herrera brand, for example, has stayed close to its core, venturing into scarves, shoes, handbags, eyewear, and fragrances. Roberto Cavalli, on the other hand, now operates service establishments such as the Cavalli Club restaurant and lounge in Dubai and Caffè Giacosa in Florence.

Luxury brands with a technical core, such as makers of jewelry or watches, tend to be more cautious about brand extension. Only a handful of jewelry brands have expanded into perfume, cosmetics, and accessories. During a panel discussion at the 2012 *Financial Times* Business of Luxury Summit, Frédéric de Narp, president and CEO of Harry Winston, opined: “There are ‘soft’ luxury goods, which stand for fashion, and ‘hard’ luxury goods, which stand for timelessness. Timelessness and hard luxury goods do not allow easily for lifestyle expansion, while fashion brands allow more easily for extension.”

The executives we interviewed noted that as they expand into lifestyle offerings, the risk they fear most is brand dilution. While about half the respondents see lifestyle as an opportunity to enter new categories or expand their customer

base, 61 percent say they are afraid such ventures may damage their brands.

We believe luxury brands can properly manage the risks of brand dilution and consumer confusion by following three steps sequentially. The order of these actions is as important as the steps themselves:

Strengthen the brand’s core and exploit its full potential. As Marc Puig, CEO of Puig, the parent company of Carolina Herrera, explained: “Each brand needs to focus on core topics and do these right, rather than branching out too quickly.” A luxury brand must communicate exactly what it stands for in everything it does—in the quality and design of its merchandise, the look and feel of its stores, and the words and images on its ads. Its essence and identity should be unmistakable to its target customers and constantly reinforced. Moving into unrelated product categories prematurely and going in unexpected directions can create unnecessary complexity and damage the brand.

Promote the brand’s lifestyle message across touch points. Once it has clearly articulated its message on its “home turf”—that is, via its core products, its own stores, and its advertising—a brand can start expanding into lifestyle offerings. It could begin by placing its products in slightly broader contexts, the way Louis Vuitton did in its “Core Values” campaign. It could articulate its lifestyle proposition across touch points, including less traditional ones such as social media or carefully chosen event sponsorships. And it could expand into adjacent product categories that are a good fit with the brand, all the while sticking to its

distinct design language. Many players choose to avoid service and experience at this stage so as not to stretch their credibility.

Expand into categories that embody the brand's identity and strengthen its association with a luxury lifestyle. Over time, a luxury-lifestyle player can offer a broad spectrum of products and experiences, so long as the entire offering is true to the brand's origins. Any additions to the product line should tie back to the core; consumers should be able to make a seamless mental connection between new categories and the brand's core assortment. Brand extensions that are too much of a departure from the brand's roots can backfire badly; they tend to be seen as crass commercialization and can alienate loyal customers.

Emphasizing uniqueness and authenticity

Our research suggests that climbing the ladder—touch point by touch point, category by category—is the wisest path for established brands. But we've also seen that new luxury-lifestyle brands can be built from scratch. A few years ago, for example, Hermès launched Shang Xia with Chinese designer Jiang Qiong Er. The Shang Xia brand seeks to project a modern lifestyle founded on Chinese design traditions and Chinese culture. In a public statement, Hermès chief executive Patrick Thomas noted, "The idea is to bring the Hermès philosophy to China, to create a Chinese Hermès." Today, the Shang Xia assortment includes apparel, jewelry, home accessories, and furniture.

Only time will tell whether Shang Xia can move beyond the confines of its home market and establish itself as a global luxury-lifestyle player. What we do know is that to achieve sustained success, a luxury-lifestyle brand must offer uniqueness and authenticity. When we asked consumers what they expect from a luxury-lifestyle brand, their answers, although diverse, underscored a common desire for something special and genuine: "it needs to be exquisite, not for everyone"; "authenticity, know-how, skilled craftsmanship"; "a certain quality of design, something original, something different."

A luxury-lifestyle brand will quickly lose its luster if it strays from its particular heritage and identity. For example, if a brand is known for high-quality leather goods hand stitched by European artisans who have honed their skills over decades, it should not be manufacturing products for its new furniture line in factories in low-cost countries. Luxury lifestyle holds the promise of growth, but brands that aspire to drive and sustain growth must stay true to their roots and "keep it real."



A luxury brand that thoughtfully pursues lifestyle can capture tremendous upside—but every brand needs to find its own way and pace. Just like traditional craftsmanship, building a lifestyle brand requires patience and meticulous attention to detail. And, just like luxury products, with the proper attention and care, luxury-lifestyle brands can become more valuable over time. ○



The euro crisis and the retail sector

In light of the uncertainty in the eurozone, retailers must watch their investments carefully.

**Stefan Niemeier and
Eckart Windhagen**

In early 2012, McKinsey published an analysis of the euro crisis that detailed and quantified the many benefits of European monetary union and outlined some serious flaws in the eurozone's design and execution.¹ Since then, the threat posed by the crisis appears to have greatly dissipated. The European Central Bank's Long-Term Refinancing Operation has distributed more than €1 trillion in three-year loans to more than 800 banks, providing relief to a beleaguered financial system. The European Stability Mechanism has also provided a lift. European national budgets are on the mend; the total deficits of the five countries generally thought most at risk—Greece, Ireland, Italy, Portugal, and Spain, or the GIIPS countries—have declined

from €260 billion in 2010 to an estimated €150 billion in 2012. Europe's politicians have begun to strengthen the union's institutions, for example, by creating the Single Supervisory Mechanism.

Perhaps the best news of all is that the imbalances in Europe's economies—the differences in growth, investment, and wages that are usually addressed by monetary policy but are now beyond the reach of countries within the fiscal union—are beginning to reverse course. The exhibit shows the balance of trade among European countries and their trading partners; the differences in the balance of trade among the GIIPS countries and their northern neighbors are becoming less noticeable.

¹“The future of the euro: An economic perspective on the eurozone crisis,” mckinsey.de, January 2012.



Bee

However, some cracks in the eurozone have only been patched over. While deficits are coming down, total debt levels appear unsustainable. Austerity budgets are not proving as successful as hoped. Our analysis of economic projections from the International Monetary Fund and the latest set of fiscal targets, embodied in the “fiscal compact,”² suggests that these targets will be quite difficult for some countries to achieve.

As a result of prolonged uncertainty, investment as a share of GDP has declined sharply; in Italy and Spain, investment is now at the same level as in the mid-1990s. Unemployment continues at

record levels, and private consumption is withering. Indeed, many believe that the crisis is now reaching its decisive phase.

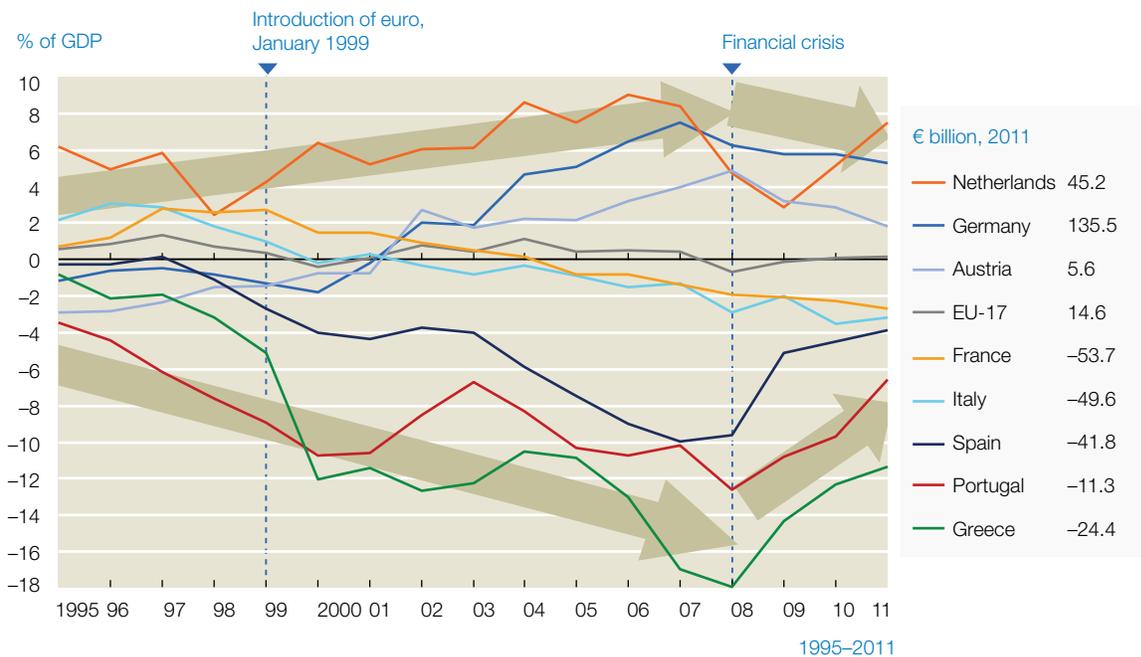
While a number of scenarios are still in play, it appears that some kind of stabilization is most likely. But each nation’s path to a stable future—and, consequently, the actions that retailers should take—will vary considerably. In the countries most affected by the crisis, retailers must find a new economic model, as lost revenues cannot be countered adequately by cuts in operating expense: rents are fixed in the medium term, and stores need a minimum number of

²The Treaty on Stability, Coordination, and Governance in the Economic and Monetary Union, signed in March 2012 and since ratified by most signatories.

Exhibit

The competitive imbalance between north and south is on the mend.

Current-account balances with the rest of the world,¹ 1995–2011



¹Net exports of goods and services + net primary income from the rest of the world + net current transfers from the rest of the world. Source: Annual macroeconomic database of the European Commission’s Directorate General for Economic and Financial Affairs; McKinsey analysis

In the countries most affected by the crisis, retailers must find a new economic model, as lost revenues cannot be countered adequately by cuts in operating expense.



workers to operate. Given these conditions, retailers face some serious questions. Should a multicountry retailer pull out, difficult though this might be because of long-term leases? Should it perhaps sell a majority stake to a local entrepreneur, with options to later sell the rest or buy it back? If it chooses to stay, what can it do to benefit from the “down trading” that pinched customers now practice? Can it attract those

customers by changing its assortment mix or by expanding its private-label offerings in lower price points? Can it selectively downsize the store network and shift sales from the shuttered stores to its online channel?

Less affected countries face a long but more assured path to recovery. But consumer spending may not drive top-line growth in the near future.

In these circumstances, retailers must consider questions such as how to win in a stagnating market while contending with the ongoing shift from physical to online retail. To what extent should they redirect capital expenditure away from expansion or refurbishment of the physical-store network to digital channels? Do they have the right balance of capital expenditure (that is, long-term bets) and operating expenditure (which provides shorter-term agility)?

In every eurozone country, two concerns are paramount. First, consider the risks associated with the supply chain. Nonfood retailers source a significant part of their goods from outside the eurozone and thus are exposed to significant exchange-rate risks. Second, this uncertainty and

the current volatility in exchange rates call for a clear strategy on whether and how to hedge this risk.



Hope for the best but prepare for the worst: that's sage advice at any time, and especially when the stakes are as high as they are in the eurozone. A good way to start thinking about the issues is with a boardroom discussion, followed by a series of scenario-based planning sessions that use the company's cash flows, product movements, and relationships to generate an understanding of the precise implications for the company in every scenario. [O](#)

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