

Reviving grocery retail: Six imperatives

In the United States and Western Europe, many traditional grocery retailers are seeing their sales and margins fall—and things could get even worse. Here's how to reverse the trend.

Dymfke Kuijpers, Virginia Simmons, and Jasper van Wamelen



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To put it bluntly, much of the \$5.7 trillion global grocery industry is in trouble. Although it has grown at about 4.5 percent annually over the past decade, that growth has been highly uneven—and has masked deeper problems. For grocers in developed markets, both growth and profitability have been on a downward trajectory due to higher costs, falling productivity, and race-to-the-bottom pricing. One result: a massive decline in publicly listed grocers’ economic value.

And it could get much worse. Monumental forces are disrupting the industry. If grocers don’t act, they’ll be letting \$200 billion to \$700 billion in revenues shift to discount, online, and nongrocery channels¹ and putting at risk more than \$1 trillion in earnings before interest and taxes (EBIT).² When the dust clears, half of traditional grocery retailers may not be around.

What has driven the grocery industry to this point? The disruption can be attributed to three major forces: consumers’ changing habits and preferences, intensifying competition, and new technologies. Each of these forces is, to some extent, always at work, but the speed and magnitude of change have caught most grocers off guard.

These disruptions present considerable—yet surmountable—challenges. Based on our research into the global grocery industry, combined with our extensive experience working with the world’s leading grocers, we have identified six imperatives for grocers to win in this rapidly changing environment.

Disruption on three fronts

In the past decade, sales growth among large grocery chains in the mature markets of North America and Western Europe has been a pallid 2 percent (compared with 9.8 percent in Africa, 8.4 percent in Eastern Europe and South America, and 6.2 percent in Asia). Even that 2 percent growth has been hard won. Between 2012 and 2017, as commodity prices and

labor costs increased, traditional grocers in developed markets couldn’t charge higher retail prices because competition from lower-priced formats—such as discount chains and dollar stores—was just too intense. Grocers’ margins fell dramatically, forcing grocers to sweat their assets. During that period, more than 50 percent of the economic profit of large publicly traded grocery retailers evaporated (Exhibit 1).

This kind of upheaval has made the industry ripe for a major shakeout. Already, consolidation is on the rise, especially within countries. M&A activity in Europe and North America is picking up again after a dip in 2016, with the recent announcement of the proposed Sainsbury’s–Asda merger exemplifying the trend. We believe consolidation will continue apace—and could eventually spell the demise of all but the two to four strongest grocery retailers in each market. These grocers will have to battle it out with the likes of Walmart, Costco, discounters, and the new “ecosystems” of Alibaba and Amazon. Grocery chains’ contribution to GDP could decline by \$90 billion or even twice that, depending on the level of automation (which would reduce retail prices and labor costs) and the size of the shift toward e-commerce.

It’s a grim picture. Of course, consumer behavior is never static, technology is constantly advancing, and new competitors are always emerging in one form or another—but the pace and intensity of all three of these forces have been unparalleled. Very few grocers have managed to turn these forces to their advantage.

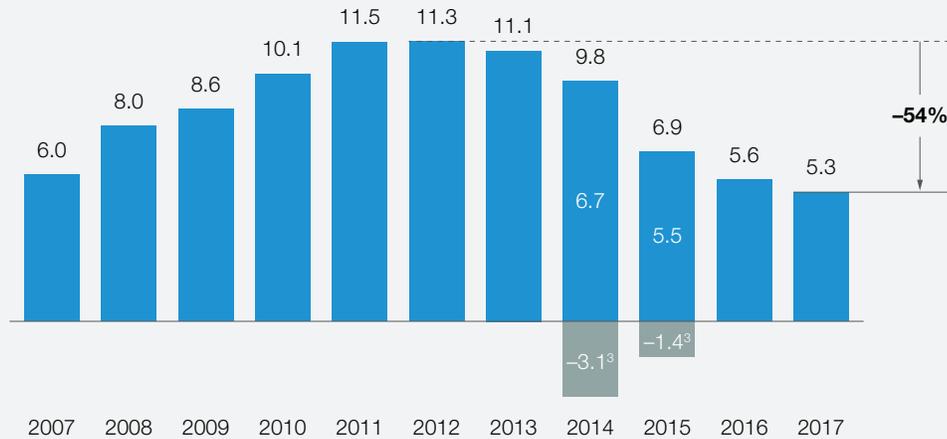
Changing consumer habits and preferences

Consumers today expect to be able to buy almost anything, anywhere, at any time—and at low prices to boot. Millennials, which now constitute the largest US demographic group, have especially high expectations. In a UK survey of grocery shoppers, millennials said they seek healthier food choices. They also want to know exactly where their food comes from and how it’s made; they expect

Exhibit 1

More than 50 percent of the grocery sector's economic profit vanished between 2012 and 2017.

Economic value add¹ of publicly traded grocery retailers,² \$ billion



¹ (ROIC - WACC) * IC: return on invested capital minus weighted average cost of capital, multiplied by invested capital.

² Analysis of 27 largest publicly traded grocery retailers worldwide.

³ Losses from Tesco accounting issues.

Source: McKinsey Corporate Performance Analysis Tool

companies to be socially and environmentally responsible and to offer sustainable, traceable products. At the same time, they want deals and discounts—not surprising, in light of the fact that they are the first generation that is less wealthy than their parents. Finally, millennials are drawn to the seamlessness and convenience of online shopping. Grocers therefore find themselves in the difficult position of trying to meet all these expectations without raising prices.

Baby boomers, too, have considerable buying power and thus are an important customer base for grocers, but present additional challenges. For one, baby boomers are different from past elder generations. They're retiring later in life; many more of them are single; many more are comfortable with technology. They're more concerned about health and wellness, they value in-store customer service, and they're more open to new products and experiences, especially those that are unique to their life stage. Grocers have to adapt

their offering accordingly while, again, keeping prices low.

One behavioral change common to every demographic group, including millennials and boomers, has posed an enormous challenge for the grocery industry: people are less inclined to cook. Almost half of US millennials say they rarely prepare meals at home. Across the board, more consumers are buying ready-made meals. In both Europe and the United States, food service is growing faster than food-at-home consumption; in the US market, food-service revenues already exceed food-at-home sales.

Aggressive competitors and the emergence of ecosystems

Grocers were slow to adapt to these changes in the consumer landscape, so other types of retailers quickly stepped in. Discounters, convenience-store chains, club stores, dollar stores, and pure-play online retailers

got into the grocery game. Consumer-packaged-goods (CPG) manufacturers began selling directly to consumers. Food-service players captured the lunch and dinner occasions.

Discounters, in particular, came on strong. Schwarz Group, which owns discounters Lidl and Kaufland, is now Europe's largest food retailer. Discounters have a market share of 20 to 50 percent in Germany, Ireland, and the Netherlands; ALDI and Lidl are beginning to flex their muscle in the US market as well. With a limited assortment and a focus on delivering great value for each item, discounters maintain higher earnings before interest, taxes, depreciation, and amortization than supermarkets, but their low prices have reduced the sector's overall revenue by about 4 percent.

Low prices are also part of the consumer appeal of online players like Amazon, which is just getting started in grocery: its acquisition of Whole Foods



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Market (WFM) is a game changer. The combination of Amazon’s digital and operational prowess, WFM’s brick-and-mortar stores, and the two companies’ customer base creates an omnichannel behemoth—a retail ecosystem that grocers have to reckon with.

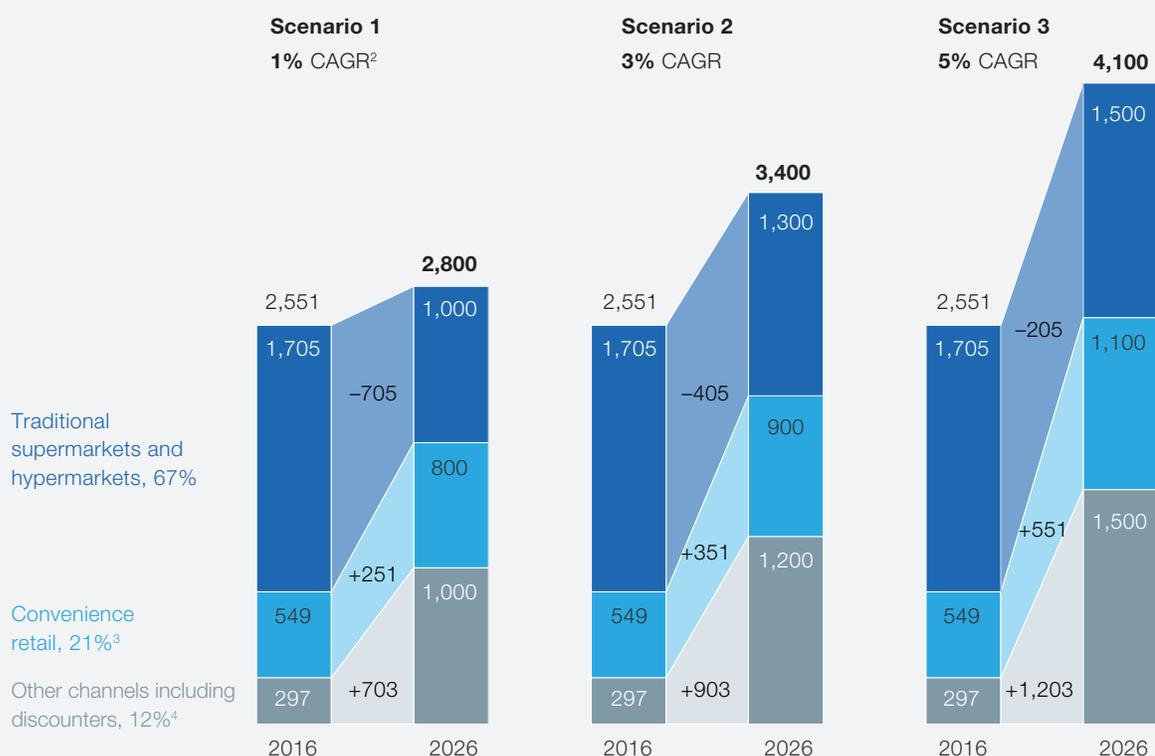
Indeed, ecosystems are emerging around the world and generating much of the growth in e-commerce. In China, Alibaba aims to seamlessly integrate online and offline channels; it calls its ecosystem “New

Retail.” Data-driven personalization, as well as network and scale effects, drive down ecosystems’ costs while locking in customers.

Our analysis suggests that, by 2026, between \$200 billion and \$700 billion in revenues from traditional grocery retailers could shift to other formats and channels—further hurting sales productivity and aggravating space overcapacity (Exhibit 2).

Exhibit 2 By 2026, up to \$700 billion will have shifted from traditional grocery to other formats and channels.

Scenarios for grocery retail sales 2026,¹ North America and Western Europe, \$ billion



¹ Channel split in 2026 of total grocery retail sales is modeled as 25–50% traditional grocery, 25–30% convenience, and 25–45% other channels.

² Compound annual growth rate.

³ Assuming 1–2% CAGR in line with food-service trends.

⁴ Other channels include discounters, online, club, and direct-to-consumer sales. Estimated growth rates are based on market-share outlook by channel (eg, discounters’ continued growth in Western Europe, 13% CAGR in United States based on recent entry of Lidl; online CAGR of 10% assuming online maturity in United Kingdom will hold for most US and Western European countries 10 years from now).

Source: Euromonitor; Verdict; McKinsey analysis

New technologies

A related (and equally disruptive) trend is the onslaught of new technologies. The success of Amazon and other online competitors is due in part to the price transparency that the digital world has enabled. To remain competitive, offline retailers have had to keep prices low even when their costs have risen.

Furthermore, most grocers haven't deployed cutting-edge technologies—including digital solutions, advanced analytics, artificial intelligence, robotics, and the Internet of Things (IoT)—as quickly and aggressively as their competitors have. For instance, Amazon's website features a robust product-recommendation engine powered by advanced analytics, the company has more than 100,000 robots transporting bins and stacking pallets in its warehouses, and it has introduced innovations to make shopping faster and easier, such as its Echo and Dash devices. Many traditional grocers find themselves constantly having to play catch-up.

Six imperatives for profitable growth

But all is not lost. Resourceful and nimble grocers have shown that it's possible not just to fend off competitors and hold on to market share but also to attract new customers and keep them coming back. Profitable growth is achievable—but it will take decisive action in each of the following six areas.

1. Define a distinctive value proposition: Convenience, inspiration, value for money

To hold their own against aggressive competitors, grocers must build a distinctive offer that emphasizes one or more of the three value propositions that have resonated with today's consumers:

- **Ultraconvenience.** Convenience is partly about having store locations that are easy to get to, such as at train stations or in residential neighborhoods. But location is only one aspect of convenience. Retailers should strive to make every part of the

shopping experience more convenient, while maintaining standards of quality far above typical convenience-store fare. A grocery store's assortment might include grab-and-go items, prepared foods, frozen meals, and loose fruits and vegetables for shoppers looking for a quick snack. It might also provide self-service options, express checkouts, home delivery, and other in-store services, such as dry cleaning or package pickup.

- **Inspiration.** A grocer can differentiate itself by creating an inspiring and exciting shopping experience that helps customers discover new products. Some grocery stores now feature digital signage that offers extensive product information, including products' origins and nutritional properties. Others try to create an environment that feels like walking through a cookbook, with fully prepared meals on display or cooked on the spot, along with recipes and ingredients in the correct portions. A grocer might decide to offer a variety of health-and-wellness options, with an unrivaled assortment of specialty, organic, and local brands. A mix of education and entertainment—for instance, cooking classes taught by a celebrity chef—can also transform the shopping experience.
- **Value for money.** This is, obviously, the value proposition of mass retailers and discounters, which means competing on this front will be highly challenging for traditional grocers. To stand a chance, a grocer would need considerable scale and a low-cost operating model. Practically, this would require expertly leveraging big data and analytics, partnering with other retailers on sourcing, and dramatically “leaning out” stores, whether through automation or by adopting a discount-store model. A more likely path for a traditional grocer might be to ensure that it's almost on par with competitors in terms of value for money, but focus on either ultraconvenience or inspiration as a differentiator.

2. Shape your ecosystem—and either go big or get out

To stay competitive against the aforementioned emerging ecosystems, retailers must make big bets on which battlegrounds to fight in and, subsequently, which digital and analytics “use cases” to master. This requires a forward-looking perspective on how consumer behavior, the competitive landscape, and technology are likely to change in five years or more. What are the potential disruptions? What will the growth areas and profit pools be? Important choices will revolve around food and nonfood assortments, payment systems, customer interfaces, service options, and last-mile delivery.

And going it alone won't work. To create an ecosystem, retailers must fill any capability gaps through partnerships or M&A—for example, by joining forces with digital, analytics, technology, or convenience specialists. The goal is to start a virtuous cycle of using data and analytics to get closer to the customer, then gathering more data with every customer interaction—and radically reducing the total costs of the system by bringing together people, commodities, and venues.

Let's look at last-mile delivery as an example. In online grocery, delivery costs are the biggest hurdle to profitability (Exhibit 3). It's a hurdle that can be overcome only with major investments in advanced analytics, warehouse relocation, and automation. If a grocer isn't willing to go big in e-commerce, it might as well get out.

Low “drop density” is the main reason for high delivery costs: a typical delivery-van driver in the United Kingdom, for instance, makes fewer than five deliveries per hour on average. Potential solutions for increasing drop density include a milkman model, whereby retailers make deliveries to communities only at specified times each week. A small Dutch

grocer, Picnic, has achieved a drop density of 14 deliveries per hour with this model.

Another potential solution is pooled deliveries, which would require grocers to collaborate with their competitors or with other businesses: for example, one player or a third-party logistics provider could combine several retailers' deliveries. In China, about 50 companies have been piloting an app that mobilizes an on-demand pool of thousands of independent drivers to deliver goods. The app contains profiles and user ratings of drivers, and it indicates whether they're available and willing to help unpack items. To aid drivers as they navigate neighborhoods, the app offers detailed trip planners and route maps.³ Early trials have indicated that this approach could shave 30 percent off retailers' delivery costs.

Another way to make deliveries cheaper is to store the goods closer to where people live. According to our analysis, if a large retailer relocates half of its distribution centers closer to city centers—from, say, 100 kilometers away to only 10 kilometers away—it could reduce delivery costs by about 10 percent.

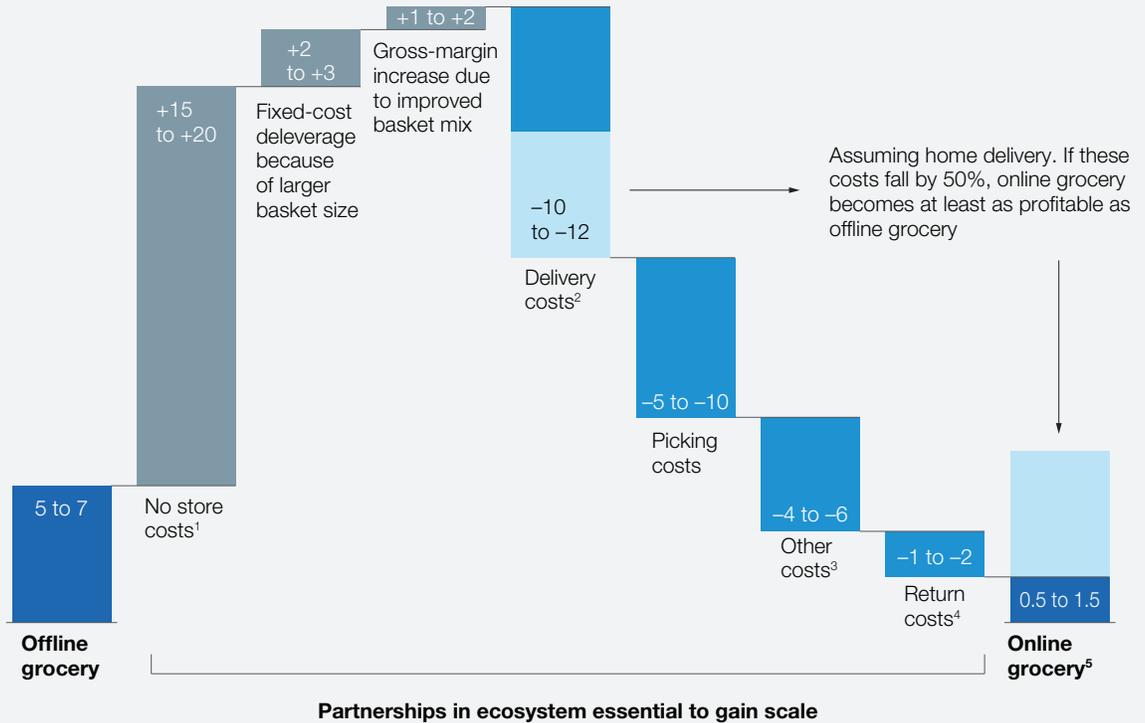
Using drones or fully automated vehicles for a fraction of deliveries could also reduce costs. But again, these solutions aren't cheap. Grocers must decide to take the plunge into omnichannel retail, or stay out altogether.

3. Put technology to work in every part of the value chain

The most successful grocers have embraced technology as the primary driver of commercial effectiveness and cost reduction across the value chain. Indeed, their use of technology is what sets grocery leaders apart from laggards; early adopters are capturing 2 to 5 percent more in EBIT than slower-moving competitors. Digital solutions, advanced analytics, and artificial intelligence can have far-reaching impact on customer

Exhibit 3 Online grocery would become more profitable if retailers can reduce delivery costs.

Profitability per basket, % of sales



¹ Such as rent or in-store labor.

² Typically, the retailer's delivery fee is lower than the actual delivery costs.

³ IT, credit-card fees, marketing.

⁴ Return costs are usually due to substitution: when an item is not available and the retailer sends a substitute, the customer sometimes returns the substitute.

⁵ Not accounting for cannibalization of offline sales.

engagement, commercial activities, store and warehouse processes, and back-office operations.

Customer engagement

In a recent survey of retail CEOs, 93 percent said they see personalized marketing as a priority. Personalization—not just of marketing messages and offers but also of product recommendations and

content—can yield up to 2 percent top-line impact. But many traditional grocers have trouble optimizing their mass promotions. Only a few grocers, such as Kroger and Loblaws, already personalize their promotions to loyal customers. More-advanced retailers are working toward “here and now” personalization efforts, which deliver the right offer at the right price, right time, and right location.

Commercial effectiveness

Advanced analytics can enable grocers to make better decisions about assortment, pricing, and promotions. Already, sophisticated retailers are creating hyperlocalized assortments while maintaining a centralized merchandising function. They're identifying which items play a unique role in the assortment and conducting space-sensitivity analysis to determine the best store-specific planogram. They're defining price zones using micromarket segmentation and comparing prices automatically with key national competitors. They're monitoring, evaluating, and tweaking their promotions daily. And they're generating insights that give them negotiating leverage over their suppliers.

In-store and warehouse operations

Up to half of in-store tasks could potentially be automated. Robots can now answer shoppers' questions, suggest items based on a shopper's previous purchases, take inventory, keep track of expiration dates, stock shelves, pick and pack products for delivery, clean up spills, and even assemble sandwiches and salads. The partnership between Kroger and Ocado, a leader in warehouse automation and end-to-end use of advanced analytics, suggests greater opportunities to offer same-day and same-hour delivery from "dark stores" with little or no staff. Retailers are testing no-checkout models: examples include Amazon Go, Ahold Delhaize's "tap to go," and China's BingoBox, a chain of unstaffed convenience stores. Since manning checkout registers represents about 30 percent of store labor—and slow checkout is among the top pain points for grocery shoppers—the benefits of redeploying that 30 percent to higher-complexity tasks would be massive.

Back-office operations

Our experience in other sectors, particularly in financial services, has shown that digitization of

back-office processes (such as accounts-payable handling or payroll processing) can yield significant productivity improvements. We often find that majority of back-office processes could potentially benefit from digitization, which can free up 15 percent or more of employees' time overall—an enormous opportunity for grocers.

4. Win back lunch and dinner

Grocery stores were once the place where almost everyone bought their lunch and dinner. In efforts to reclaim that role, many grocers have expanded their selection of ready-made meals and prepared foods. Some are bringing master chefs into the store.

There are several different models for food-service execution, including having a full-service restaurant next to the supermarket, dedicating a section of the store to ready-made meals or in-store dining, operating a "food hall" that has restaurants as well as retail shelves, and introducing store-in-store concepts that focus on niche foods (such as the Sushi Daily counters inside select Waitrose stores). In addition, many grocers—recognizing the growing consumer demand for healthy meals at home—are finding ways to meet that demand. In China, for instance, food retailers such as Hema and 7Fresh are offering home delivery within 30 minutes.

To succeed in food service, grocers must think through their approach by agreeing on answers to the following questions:

- Which archetype will we pursue (food for now, food for later, or both)?
- What store space will we use?
- Who will operate the food-service offering—in-house staff or a third party?

Some store space could conceivably be reallocated to fulfilling online orders or providing other services.

- What brand will it carry (a store brand, an existing food-service brand, or an entirely new brand)?
- Should we offer fast delivery? If so, what's our plan for making last-mile delivery work?

Of course, each grocer's answers to these questions will depend on a number of variables, including its particular strengths and weaknesses, the customer segments it serves, and the local competitive landscape. In some inner cities, popular food-service players have a higher density of outlets than the leading grocers.

5. Rethink all of your real estate

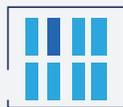
Grocers must get creative with their real estate. Closing stores is certainly an option, but it shouldn't be the first or only one that they consider. For starters, grocers must think ahead to the future needs of their online businesses; some store space could conceivably be reallocated to fulfilling online orders or providing other services.

Retailers can address overcapacity in their portfolio in several ways (Exhibit 4). Options include reinvigorating core categories within a store, repurposing certain areas of the store, renting out

Exhibit 4 Grocers can address overcapacity in a number of ways.

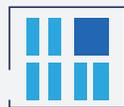
Potential levers for addressing real-estate challenges

Reinvigorate



Invest space in core or "battleground" categories to drive foot traffic and to differentiate from discounters

Repurpose



Add new categories and services (eg, cafe, sushi bar)

Rent out



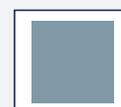
Bring in tenants and create shops-in-a-shop for "halo" benefits

Right-size



Shrink the store's footprint and sell or rent a portion to another business

Remove



Close the store; sell building or end lease while maximizing profit

Reinvent



Unlock property value by redeveloping the site as a mixed-use site (eg, with residential)

space to other businesses, right-sizing the store, removing it from the network entirely, or redeveloping it as a mixed-use property, perhaps with residential space—an especially palatable solution in regions with housing shortages.

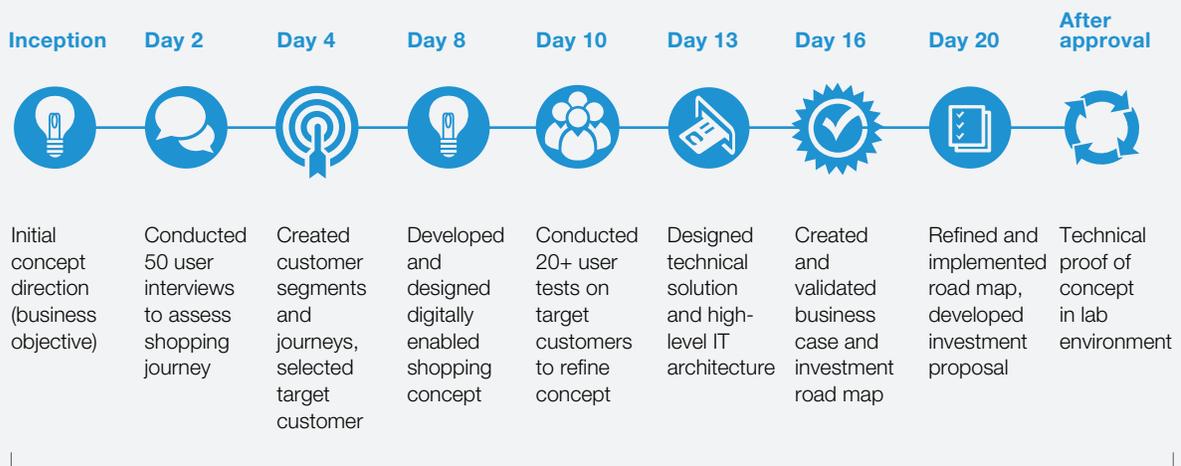
The most forward-thinking retailers, recognizing their need to raise capital and reduce liabilities, are collaborating with property developers and land owners—entities that have the requisite balance sheet, capabilities, and relationships with local authorities. In partnership with these entities, they can come up with options for the entire store portfolio instead of evaluating each store independently.

6. Innovate ten times faster

Speed is critical, which means grocers must jettison their traditional—and slow—approach to implementing new initiatives. They should instead take an agile approach using “concept sprints.” Characterized by quick decision making, a focus on tangible outcomes, constant customer validation, colocated and multidisciplinary teams, rapid iteration, and careful attention to internal capability building, concept sprints can reduce time-to-market from four to six months to just four weeks.

Exhibit 5 shows how concept sprints can be used across the organization to accelerate the launch of

Exhibit 5 Concept sprints can be used across the organization to speed development of priority initiatives.



Using this approach, team developed proof of concept ~5x faster (4 weeks vs typical 4-6 months)

high-priority initiatives. Leading retailers have used such an approach to introduce new in-store digital solutions, refine picking algorithms in warehouses, or develop new products.



For traditional grocery retailers, a return to profitable growth won't happen without tough decisions and bold moves. The competitors that are already eating grocers' lunch (and dinner, too) are moving quickly, and they're harnessing the power of technology to improve operations and relentlessly pull customers away from traditional grocery stores. It's up to grocers to fight back—and perhaps join forces with each other (within the bounds of anticompetition and antitrust laws, of course)—to regain scale and effectively compete in the fast-changing and hotly contested food retail market. ■

¹ Scenario-analysis estimates based on 2011 to 2016 observed market and market-share growth rates.

² Estimate considering additional labor costs required to meet rising consumer expectations for in-store service, assuming costs cannot be passed on to consumers.

³ Lambert Bu, Yuanpeng Li, and Min Shao, "An 'Uber' for Chinese e-commerce," *McKinsey Quarterly*, January 2017, McKinsey.com.

Dymfke Kuijpers (Dymfke_Kuijpers@McKinsey.com) is a senior partner in McKinsey's Singapore office, **Virginia Simmons** (Virginia_Simmons@McKinsey.com) is a senior partner in the Chicago office, and **Jasper van Wamelen** (Jasper_van_Wamelen@McKinsey.com) is an associate partner in the New Jersey office.

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