What China's grocers need: A recipe for reinvention
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Preface

What China's grocers need: A recipe for reinvention

As the Year of the Pig begins, business leaders in China face more volatility and uncertainty than they have in recent years. Consumer confidence is on the decline, geopolitical concerns abound, and macroeconomic forces are giving retailers plenty to worry about. In fact, China today has one of the least productive grocery retail networks (as measured by sales per square meter) among markets where modern trade enjoys a relatively large share. And scaling up across the country isn't easy, given the stark regional differences among Chinese consumers.

Yet, despite these challenges, we believe the medium- to long-term prospects of the country's grocery retail sector are stronger than ever.

Why are we optimistic? It's because we're extremely confident in Chinese retailers' ability to innovate. Indeed, in recent years, China has become the global reference for retail disruption. Companies around the world recognize China's retail industry as a hotbed of innovation at speed and at scale, and as a model worthy of emulation. Grocery retailing is at the heart of all this innovation, with creative new concepts such as Hema and 7FRESH resonating with Chinese consumers and attracting the interest of grocers worldwide.

To address this growing interest, we at McKinsey have intensively analyzed the New Retail ecosystems, including Alibaba and Tencent, to uncover the myths and realities behind them. We're convinced that New Retail is here to stay and that its impact will only grow and accelerate. We now offer a "New Retail Bootcamp," a structured program that allows our clients around the world to take a close look at how leading Chinese players are fundamentally—and profitably—transforming retail, both inside and outside the store.

Some of you, too, have embarked on your own transformation journeys and are well on your way toward reinventing your business. In our recent survey of grocery executives in China, respondents highlighted the following priorities: significantly investing in fresh food, developing online-to-offline capabilities, rethinking large formats, rebuilding the fundamentals (e.g., supplier management), and driving cost-optimization programs to fund new growth areas.

While there will certainly be fierce competition along the way, we believe traditional grocers that boldly reinvent themselves can emerge as the winners in China's grocery sector. It will be a matter of complementing core competencies (such as merchandising, pricing, and sourcing) with cutting-edge technological and digital skills. The articles in this compendium represent our latest thinking on these crucial capabilities. Combined, they suggest a recipe for success.

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How are consumers feeling about their finances?

In many countries, consumer sentiment has improved since 2015. Consumers have become more bullish about their ability to spend.

Max Magni, Anne Martinez, Rukhshana Motiwala, and Alex Rodriguez

More consumers around the world are enjoying a sense of financial stability. In our third annual Global Consumer Sentiment Survey, conducted in September 2017 in 29 countries,[1] respondents were more upbeat about their finances compared with the previous year. Fewer consumers said they were delaying purchases, cutting back on spending, and feeling uncertain about the economy. Across the globe, more consumers said they traded up to more expensive brands, while fewer consumers reported trading down to cheaper options (Exhibit 1).

The results of our latest survey indicate a further strengthening of the trends we summarized in our May 2017 article.[2] For instance, the shift to e-commerce is happening even faster than it was last year, not just in China and India but almost every where. And it's happening not only among aff luent consumers but across all income tiers.

In addition, the latest survey results highlight three interesting trends that have implications for how consumer-packaged-goods (CPG) companies and retailers should pursue growth. More than half of consumers said they changed their buying behavior in one way or another within the past year. Specifically, we found that consumers are continuing to abandon midmarket brands, thrift manifests itself in different ways in different parts of the world, and health-conscious consumers aren't necessarily buying natural or organic products.

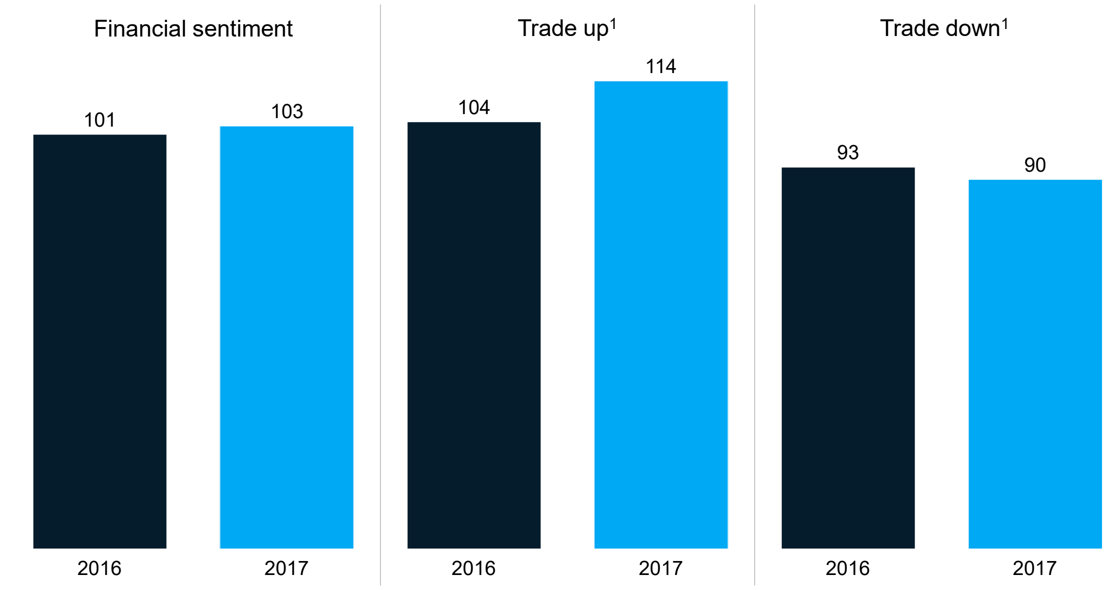
1 The survey garnered responses from more than 28,000 consumers, representative of approximately 80 percent of the world's consuming class. Because the survey was administered online, the sample largely reflects the characteristics of the typical online population—younger, urban, and more affluent.

2 Max Magni, Anne Martinez, Rukhshana Motiwala, and Alex Rodriguez, "Consumer sentiment around the world: Trending upward," May 2017, McKinsey.com.

Exbiti 1

In 2017, consumers felt better about their finances, leading to more trading up and less trading down.

Global respondents, index, 2015 = 100



1 In standard shopping basket of fast-moving-consumer goods categories.

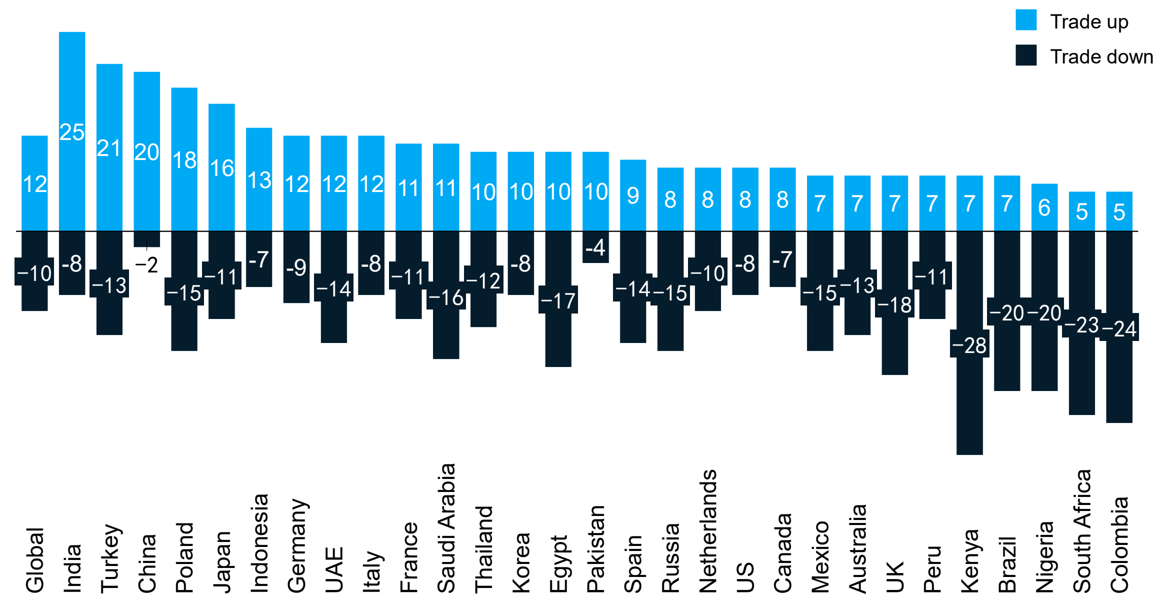
Source: McKinsey 2016–18 Global Sentiment Survey

Exbiti 2

The highest trade-up rates are in India, Turkey, and China.

Stated behavioral shifts in the past year among those who changed buying behavior,

Weighted average for categories, %, 2017



Source: McKinsey 2018 Global Sentiment Survey

Still moving away from the middle

Consumers continue to either trade up or trade down, moving away from midmarket brands. Although globally the trade-up trend is slightly stronger than the trade-down trend, the survey results show vast differences at the country level. Last year, when we saw a marked increase in trade-up behavior among Indian consumers, we predicted a continuation of that trend—driven largely by rapid urbanization, the expansion of modern retail outlets, and premiumization in several CPG categories including beauty products, beverages, and packaged food. Indeed, the latest survey shows that India had the highest trade-up rate, at 25 percent (Exhibit 2).

Turkey and China, too, had trade-up rates of 20 percent or higher. Turkish consumers have been active up-traders over the past two years. In the 2016 the latest figure is, unsurprisingly, down slightly, due to tougher economic conditions in Turkey. In China, gains in consumer confidence have led to increases in discretionary spending.[3] A mere 2 percent of Chinese consumers said they traded down.

In some Latin American and African countries, on the other hand, trade-down rates were upward of 20 percent, whereas trade-up rates were in the single digits. Consumer companies should note that in these developing economies, down-traders often opted for lower-priced branded products rather than retailers' private-label products. Take nonalcoholic beverages, for instance: only 19 percent of down-traders in Latin America said they switched to private-label products in this category, whereas in North America, 73 percent of down-traders did so. We observed the same pattern in a number of other CPG categories, including food and household products. CPG manufacturers should therefore consider launching— and aggressively marketing—branded products in entry-level price tiers in these countries.

What it means to be thrifty

The most prevalent changes in spending behavior varied greatly by country. Even among consumers who sought to save money, the preferred methods for doing so weren't necessarily the same from one country to the next.

In many countries, including the United States,[4] 39 percent of those who reported a change in buying behavior said they still buy their preferred brands but at stores with lower prices. Compared with 2015, fewer US consumers said they waited for discounts or clipped coupons, suggesting that US bargain hunters, once they've found a cheaper retailer, begin to spend more freely at that retailer. This trend underscores the importance of channel strategy for CPG companies: they need to build a strong presence in channels that are perceived as low priced, such as club stores, discounters, and certain online retailers.

[3] Wouter Baan, Lan Luan, Felix Poh, and Daniel Zipser, "Double- clicking on the Chinese consumer," November 2017, McKinsey.com

[4] For highlights from the latest US Consumer Sentiment Survey results, see Max Magni, Anne Martinez, Rukhshana Motiwala, and Alex Rodriguez, "More Americans feel financially secure, but they've learned new shopping habits," February 2018, McKinsey.com.

By contrast, in China, consumers were less likely to switch stores to save money. Instead, they opted to buy their preferred brand in smaller quantities. Globally, almost one in four consumers said they do this. Many consumer-goods companies have in troduced smaller pack sizes, allowing consumers to sample—and, in time, become loyal to— established brands. Colgate-Palmolive, for instance, has long sold its oral-care and household products in small packets and sachets. In Central and West Africa, Nestlé launched an initiative called My Own Business, through which entrepreneurs sell hot coffee by the cup from specially designed backpacks. The initiative has made loyal Nescafé drinkers out of consumers who might not be able to afford an entire tin of instant coffee.

The waning appeal of ‘natural’ and ‘organic’

Worldwide, 31 percent more consumers said they're eating healthier food, continuing a trend we've observed over the past two years. However, the latest survey results also show that consumers today aren't necessarily equating healthy eating with buying products that are labeled “natural” or “organic.”

In Western Europe, there is still some growth in natural and organic products. For example, in Italy and France, survey respondents who claimed to have increased their purchases of natural and organic products outnumbered those who said they'd reduced such purchases, by 13 percent. Western European consumers are also continuing to show greater interest in buying locally sourced food.

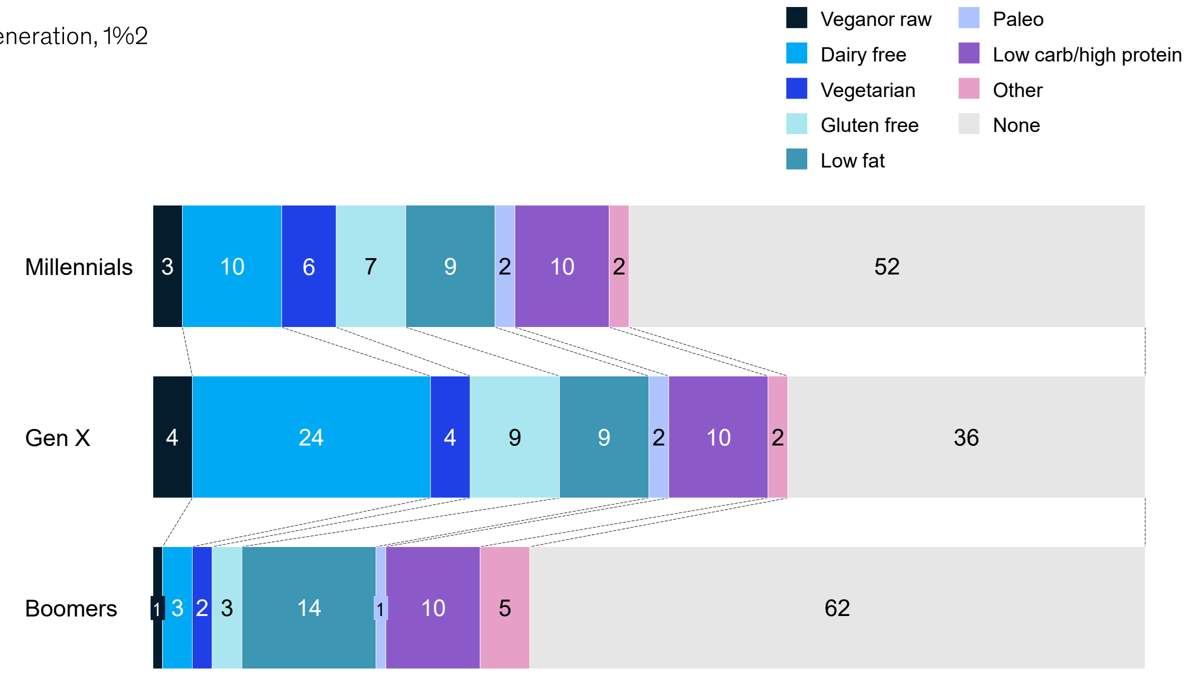
But in the United States, consumers seemed not to be too concerned about whether food products are labeled either natural or organic, or whether they're locally sourced. Instead, among US consumers, eating healthy increasingly means carefully reading nutrition information and ingredient lists. This is in part because more US consumers are adhering to a specific “food lifestyle”: another recent McKinsey survey showed that 10 percent of consumers across all age groups say they stick to a low-carb or high- protein diet (Exhibit 3). Some consumers eat only dairy-free foods. Other food lifestyles include gluten-free, vegetarian, and paleo.

Exbiti 3

Many US consumers are adhering to a specific ‘food lifestyle’

US consumers who say they follow a specific food lifestyle,

by generation, 1%2



1 Respondents: 7,000 millennials (ages 20–34), 2,500 Gen X (35–50), 2,000 baby boomers (51–69)
2 Figures may not sum to 100%, because of rounding

Source: McKinsey Millennial Survey, May 2016

CPG companies are responding to this trend, either by launching new products and brands of their own or by acquiring smaller, fast-growing health-and- wellness players. General Mills now has nearly 1,000 gluten-free options in the US market alone. Mars took a minority stake in KIND Snacks, which was among the first companies to participate in the “clean labeling” movement (meaning that its list of ingredients is typically short, simple, and contains no artificial additives).

Our annual survey provides a snapshot of consumer sentiment and evolving consumer behavior, with important nuances by country and region. Companies that stay keenly attuned to how consumers are feeling and how they are making purchase decisions will be best able to plan for—and capture—profitable growth.

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Double-clicking on the Chinese consumer

The new health craze, the rise of the post-90s generation, and other trends worth watching

Wouter Baan, Lan Luan, Felix Poh, Daniel Zipser

Over the past dozen years, we've been taking the pulse of the Chinese consumer through our annual and bi-annual surveys. In this relatively short span of time, we've witnessed dramatic changes in their behavior and attitudes towards what they buy and how they shop.

From being hyper-conscious about extracting the most value for their hard-earned renminbi just a dozen years ago, Chinese consumers today are earning much more money, and are spending that money on a wider variety of higher quality and pricier goods and, increasingly, on services.

But with wealth comes choices, and Chinese consumers have more choices than ever before. Understanding how Chinese consumers make the critical decisions that impact what they buy—and what they don't—is a critical skill that any company in China needs to master if they hope to succeed in this hotly contested market.

Digging deeper into the attitudes and behaviors of consumers reveals a much more multi-faceted set of consumer segments, each with unique characteristics that determine their shopping habits. This is what we've done with our latest survey of nearly 10,000 consumers aged 18 to 65 across 44 cities and seven rural villages and towns.

Of all the observations we've made of the Chinese consumer over the past dozen years, one has become very clear in this year's survey: The "Chinese consumer" no longer exists. And what do we mean by this? Mapping the broad trends in consumer behavior is important—but big picture trends no longer provide the nuanced insights into consumer behavior that marketers need to make their decisions.

As in previous reports, we present four key trends companies need to know to help them formulate their operational strategies in China, from marketing to M&A. But this time, we dig deeper into each of the trends, and in doing so, we reveal deeper, more meaningful layers of insight into what makes Chinese consumers tick today.

Here are the trends we explore in this report:

Consumer confidence has reached a ten-year high, but risks remain. The rising cost of real estate, the need to pay for children's education, and the need to support elderly family members in a greying society combined with slowing income growth and rising prices, are casting a long shadow on what is otherwise a very bright outlook for Chinese consumers.

Consumers are more health-conscious than ever before—but different consumers define health differently, and this varies, too, against western notions of health. This impacts their spending decisions and lifestyle choices.

The "post-90s" generation is emerging as the next engine of consumption in China. Aged 17-27, they're digital natives – born with the internet – and they're working, earning money, and making decisions as to how they spend it.

When it comes to spending money, Chinese consumers are taking a more nuanced view of global versus local brands. Brand origin is less relevant among Chinese consumers who are looking for quality, value, and service.

Trend #1: Consumers are confident—but risks remain

Business leaders and marketers in China often ask: How confident are consumers? Confidence helps to define market strategy and identify growth opportunities. The answer to this question, as of the writing of this report at least, is "very confident."

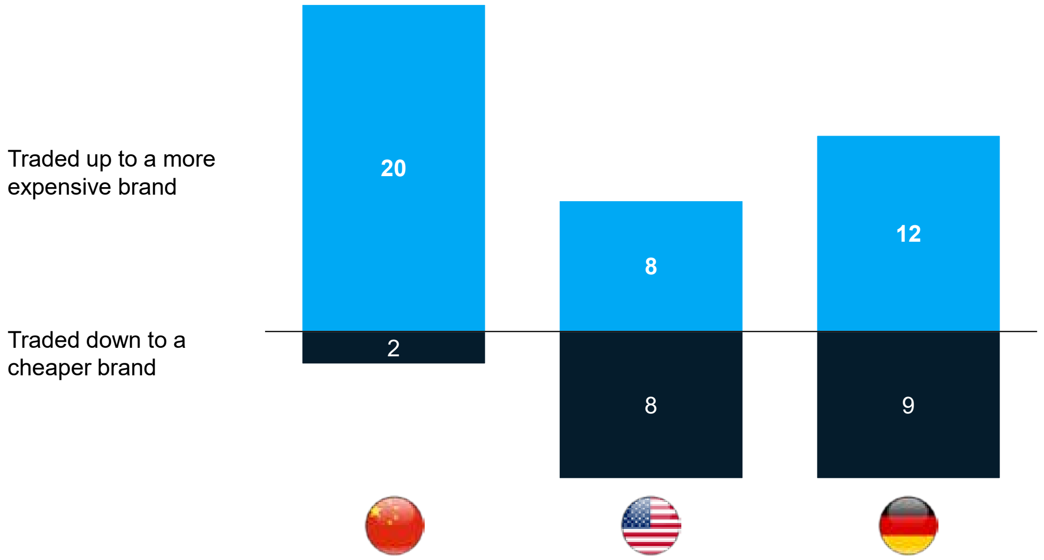
Since our last survey, which we published in early 2016, consumer confidence has grown significantly in China to reach a ten-year high. China's Consumer Confidence Index rose from a low of 100 in the spring of 2016 to 115 in August of 2017, a level that exceeds what the Index had reached back in 2007, right before the onset of the global financial crisis.

On the back of this rise in confidence, consumers have been spending more on discretionary items, a trend driven in part by their desire to trade up to more premium brands, per another recent survey we conducted. (Exhibit 1)

Exhiti 1

Trading up (and down) in key FMCG1 categories: China, US, Germany

% of survey respondents



Double-click: Singles Day sets a new record

If you're looking for evidence that Chinese consumers are confident, look no further than the one-day online sales phenomenon known as Singles Day, which falls every year onNovember 11. Singles Day, which was initiated and continues to be hosted by China's ecommerce giant Alibaba, has morphed from being a day dedicated to lonely singles, to becoming the single largest e-shopping day globally. With an estimated $25 billion in sales on Alibaba. com and a further $19 billion on JD.com - China's two largest ecommerce platforms - Singles Day this year easily bested last year's sales by close to 40 percent, and was larger than Black Friday and Cyber Monday in the US combined.

Will confidence remain high or continue to rise? Perhaps, but speculation on this matter can be risky. While consumer confidence has been on an upward trajectory for the past 15 months, the overall pattern in the past decade has been more volatile, with confidence dipping down to as low as 97 in 2012 and 2013, and then swinging upwards to about 107 during several periods, before falling back down again.

There are several reasons to take a more cautious stance towards the future starting with the very high levels of debt that the Chinese economy overall, and households, are taking on. In 2017, the total leverage ratio in China hit 266 percent, the highest level it has ever reached. Meanwhile, household debt reached 50 percent, the highest it has been since the government started recording this figure, albeit still lower than developed countries. Debt levels aside, the real driver of spending is income growth, and this has slowed considerably, dropping from 10.1 percent in 2012 to 6.3 percent in 2016.

Chinese consumers are also running up against rising education costs and higher real estate costs, especially in tier-1 cities, despite government measures to cool the market.

While these are all relatively short-term indicators, longer- term, the rising cost of caring for elderly family members, particularly the healthcare expenses associated with such care, is set to become one of the biggest burdens on the budgets of Chinese consumers.

Trend #2: Consumers are more health- conscious than ever before—but different consumers define health differently

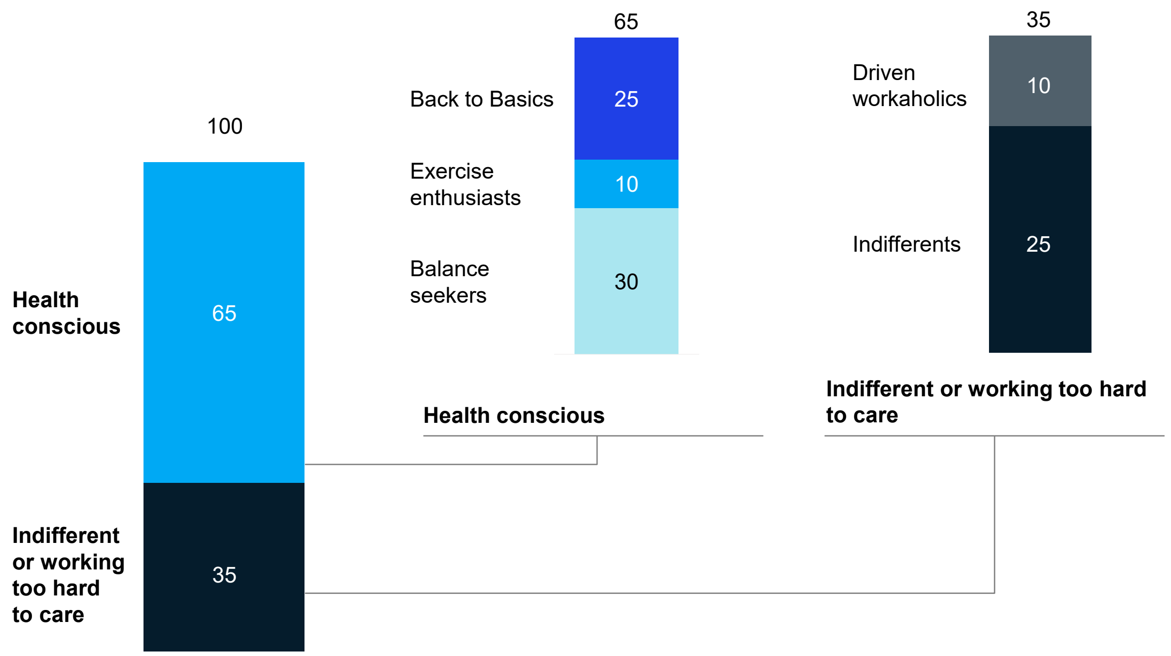
Bigger paychecks mean more disposable income to spend on health and fitness; this is a positive outcome of China's economic boom and, like western societies, the health and fitness trend is most evident among wealthy urbanites.

While we've been tracking their attitudes toward health for nearly a dozen years now, in the past few years we've noticed a substantial uptick in the number of Chinese consumers concerned about their health and the impact that diet, exercise, and the environment have on their quality of life. Our survey showed that 65 percent are seeking ways to lead a healthier lifestyle. (Exhibit 2)

Exhiti 2

Chinese consumers' attitudes toward healthy living

% of survey respondents



Double-click: Junk food backlash

After years of heady growth, rising consumer awareness of the importance of health appears to be putting the brakes on some of the less nourishing food and beverage categories:

— 41 percent said 'almost never' to eating unhealthy food.

— The instant noodle and soda markets shrank by 7 percent and 2 percent respectively in 2016 compared with 2015.

— Fast food chains, already thought of as healthier than 'holes-in-the-wall' and roadside stalls, continue to expand with healthier menu options.

But this belies a more worrying trend. Millions of Chinese consumers have access to, and can afford, more types of food than ever before, and their bulging waistlines are evidence of this phenomenon.

Thirty percent of Chinese adults—roughly 320 million people—are overweight and about 6 percent obese.

While in percentage terms this number might still lag the extraordinary rates of obesity seen in the West, in sheer absolute numbers, China today has the largest population of overweight people in the world.

The government has responded: In 2016 it announced the "Healthy China 2030 plan", which pledged to promote initiatives geared towards diet, exercise, and access to healthcare services.

Healthy living with a Chinese twist

Chinese consumers' interpretation of healthy living, in general, differs greatly from western views. While the latter has long-advocated vigorous exercise regimes and high-protein, low-carb, low-fat diets, Chinese people have, historically, focused on the harmonious balance of mind and body. Foods are valued for specific properties, for example, their "heating" or "cooling" effects, while traditional forms of exercise, like tai chi, are low impact and focus on restoring positive flows of energy.

Of course, Chinese consumers don't all share the same views toward health. Through our survey this year, we identified five distinct segments of consumers based on their different attitudes toward health. Three segments, representing 65 percent of our respondents, are deeply concerned about this issue, but express it in very different ways. (Exhibit 3)

Back to Basics

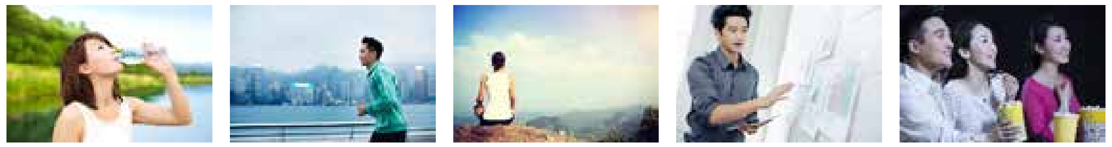
The "Back to Basics" segment, which comprises 25 percent of respondents, love nature and seek out natural products.

This group takes a natural, holistic approach to health and wellness. Instead of stressing about their personal and work life, 73 percent said they are focused on having fun and being close to nature.

They care less about appearance, and pollution and food safety are big concerns. They buy natural and organic food whenever possible – 55 percent versus 43 percent on average – and, while they are more willing to try health apps, especially calorie-counting and pulse monitors, they're less willing to pay for them.

Exhiti 3

Different consumers define health differently



	25% Back to Basics	10% Exercise enthusiasts	30% Balance seekers	10% Driven workaholics	25% Indifferents
Core belief	Having a healthy and comfortable living environment defines health	Exercising regularly Eating healthy	Seeking balance among physical, mental health and harmonious social life	Having a healthy appearance	Generally less interested in leading a healthy lifestyle
Key concerns / barriers	Environmental pollution Food security	Lack of exercise Irregular diet schedule	Similar concerns as naturalists and exercise enthusiasts	Lack of sleep Financial stress	More stressed from fast-paced lifestyle
Behavior	**More than 50%** buys natural and organic food **72%** would like to stay close to nature for leisure activities	**5% more[1] people** prefer food with less oil and additive **9% more people** take more health supplement	**8% more[1]** emphasis on fresh ingredients for healthy food **8% less[1]** people willing to trade off personal time for work	**6% more[1]** prefer imported ingredient **5% more[1]** prefers doctors endorsement	**10% more[1] people** thinks it is important to ensure having enough leisure time to enjoy hobbies and life

1 Compared to the overall sample population

SOURCE: McKinsey China 2017 consumer survey

Balance Seekers
"Balance seekers", who account for 30 percent of respondents, are looking to strike equilibrium across all dimensions of health, including physical fitness, mental health, and their relationships with others.

This group wants to look and feel good. While 53 percent desire a strong physique, 60 percent said their state of mind was more important, along with social life and relationships. To the "balance seekers", having a happy family is a better indicator of success than amassing wealth. Sixty-nine percent, compared with 61 percent on average said they would be less willing to trade off personal time for work.

That said, when it comes to fitness, these individuals are more willing to spend money on sports activities and buy specialized sportswear with 69 percent admitting to buying running gear compared with 47 percent on average. They will pay for health apps, particularly step counters and pulse monitoring.

Exercise Enthusiasts
Another 10 percent of consumers are "exercise enthusiasts" who—not surprisingly—love to exercise. This is driving a surge in sales of exercise clothing and equipment.

One hundred percent of this body conscious group said that exercising regularly is key for leading a healthy lifestyle. They're driven by a desire for physical strength and athletic ability. They care less about pollution, peace of mind and social relationships.

This mentality extends to diet and just over 50 percent of the enthusiasts avoid unhealthy food, specifically, oil and additives; they take more supplements; buy more fresh food, and take regular physical exams.

Their favorite activity is running – about 50 percent of the exercise enthusiasts run on a regular basis (at least twice a week) and apps such as step counters, weight monitoring and customized workouts and fitness apps appeal to them.

"Driven Workaholics" & the "Indifferents"
The remaining one-third of respondents we surveyed spend little time worrying about their health. About 10 percent of them claim to be "driven workaholics" who are too busy for healthy living; the other 25 percent are indifferent about their health.

That's not to say they can't eventually be converted. Over time, consumers who belong to one of these segments are likely to become more conscious of their health, and may start to take action toward improving it.

Double-click: Let's get physical

Adidas announced it plans to open 3,000 more stores over the next three years, bringing its total to 12,000 stores. Reebok, which is owned by adidas, plans to open 500 stores in three years. Specialist sports brands are fast gaining a following, too. As of November 2017, yoga apparel brand, Lululemon, had 10 stores in mainland China, having entered the market in 2016 with just three outlets. French sporting goods and apparel chain Decathlon grew sales by 34 percent in 2016 on the back of 51 new store openings, which brought its total in China to 214 by year-end.

Double-click: Fueling the fitness trend

More than 40 percent of respondents said they exercise regularly and although gym membership and sports event penetration lag developed countries, they are rising rapidly. There are more than 15 million membership card holders in China today and sports apps are capturing an astonishing number of users, with over 65 million active users as of the end of 2016.

When it comes to fueling the body, a growing number of health food stores and F&B outlets offering "clean" and "green" produce are catering to a new wave of clued up, calorie- counting consumers. In addition, China's thriving food delivery services are beginning to offer healthier options such as salads and gluten-free and dairy-free options.

Double-click: Nike+ Run Club

Nike appeals to health - conscious Chinese consumers with its Nike+ Run club, an app that not only tracks running and provides a virtual coach but connects runners in the same community through Nike running clubs. This naturally leads participants back to Nike running shoes. Having placed the consumer, rather than the product, at the center of its strategy, Nike has benefited in both engagement and sales. The app appeals to the largest exercising population in China (50 percent of its runners say they run regularly), and it promotes healthy living, as well as its products, through the community.

Perception vs reality

While there seems to be growing consensus on the merits of leading a healthy lifestyle and all it entails, a mismatch exists, at times, between perception and reality in ways that are unique to China. For example, our survey showed that 39 percent believe that ambient yogurt is as healthy as chilled yogurt despite containing no probiotics, live bacteria and yeasts that are beneficial for the digestive system.

Food safety is important to Chinese consumers. Forty- one percent said they choose only to order food from trusted restaurants as they know the food is safe, and 60 percent claimed they cook at home as much as possible mainly because of food safety concerns.

Lepur, a local yogurt brand that markets itself as healthy and safe, is using its positive food safety credentials to gain appeal. In Beijing, Lepur's glass-enclosed kitchen is visible to the public so they can address any food safety concerns consumers may have. The feedback they get from consumers informs their development process and, through this collaboration, consumers gain confidence in the yogurts' ingredients and health benefits.

Key takeaways

The three key segments – the "Back to Basics", "Balance Seekers" and the "Exercise Enthusiasts" – will become more important and companies will need to create thoughtful messaging and marketing. Drilling down into the detailed nuances of this vast and complex consumer group is key to success.

Although China is still in the nascent stage of its health awareness journey, forward-thinking companies have an opportunity to shape perceptions by partnering or aligning with trade associations, education institutions, and regulatory bodies.

Carefully constructed, multi-platform, marketing campaigns are essential. Companies in the health and fitness space must think beyond the product and create a broader offering. Tapping into China's massive online communities, for example, with health and wellness information, will allow companies to connect the dots between the product and a lifestyle proposition.

Trend #3: The "post-90s" generation is emerging as a new engine of consumption

Our research this year shed new light on one of the fastest-growing and increasingly influential segments of Chinese consumers—what we call the "post-90s generation." While many reports in recent years have grouped China's younger generation under the familiar term, "millennials," this term doesn't fully capture the unique attributes of this segment of the population, which we define as people born between 1990 and 1999.

This generation exhibits very different behavior and attitudes not only with older generations of Chinese consumers, but also the generation that we call the "post- 80s", which is generally lumped together with the "post-90s generation" in media reports that cover this topic. They also differ to western millennials.

The post-90s generation grew up in a China unknown to their parents, one marked by extraordinary levels of wealth, exposure to western culture, and access to new technologies. Comprising 16 percent of China's population today, this consumer cohort is, by our projections, going to account for more than 20 percent of total consumption growth in China between now and 2030, higher than any other demographic segment.

It's a diverse group of consumers, as we discovered when we asked them their attitudes toward certain areas of life: success, health, family, brands & products, and their future.

Exploring how this group defines success, or how they choose brands and products, yielded, in many cases, very different answers. Based on their beliefs and attitudes, we sorted them into five distinct segments. (Exhibit 4)

Exbiti 4

5 distinct segments of the post-90s generation show different general and consumer attitudes

25%

Happiness seekers

86% believe success means pursuing a happy life (vs. 43%[1])

54% not concerned about brands, but the actual product (vs. 44%)

53% willing to pay extra for environmentally friendly products (vs. 46%)

10%

Success seekers

64% believe success means being rich (vs. 55%)

58% buy what they like (vs. 41%)

Less likely to save for rainy days: only 28% believe one should always prepare for uncertainty (vs. 39%)

30%

Laid backs

Only 32% believe that "as long as you work hard, you can change your life"(vs. 45%)

Less likely to pay a premium new technology (27% vs. 37%)

10%

Spendthrifts

48% willing to spend to try new things (vs. 34%)

38% believe expensive products are better (vs. 25%)

42% proud to afford small luxury items to show their taste (vs. 33%)

25%

Homebirds

96% have parents paying for big ticket items (vs. 21%)

47% willing to pay for the latest technology (vs. 37%)

54% seek for and pay a premium for good quality item (vs. 41%)

1 Statistics for the total survey population shown in brackets

SOURCE: McKinsey China 2017 consumer survey

The "Happiness Seekers"

What we call the "happiness seekers" make up 39 percent of the post-90s generation, the largest single segment. Born after 1995, this group is young and comprised primarily of students. Despite concerns about supporting their parents financially later in life, they're confident about their overall economic outlook, however, they define success in terms of their own happiness rather than material possessions. Eighty-six percent, compared with 43 percent of overall respondents is focused on pursuing a happy life and far less concerned about brands, and what they might represent to their peers.

These consumers value quality and will do their research before shelling out their hard-earned money for things: 55 percent frequently check labels and ingredients, versus 47 percent of overall respondents. Fifty-three percent say they would pay a premium for an environmentally-friendly product, versus 46 percent of overall respondents. And 54 percent emphasize what they're getting from a product over the brand, compared with 44 percent of respondents overall.

Companies have an opportunity to shape their spending habits and preferences, which are likely to change as they mature.

The "Success Seekers"

The "success seekers", the second largest segment (27 percent), are largely well- educated and white-collar. It's no surprise then that they admit to feeling stressed about their current life and their future. Unlike the "happiness seekers", happiness does not factor in their definition of success. They see success as getting rich (64 percent versus 55 percent of the average post-90s consumer).

Perhaps as an outlet for the day-to-day pressures they bear, this hard-driving segment of young consumers are more likely to reward themselves. They don't believe in saving for a rainy day and, instead, buy what they like, when they like.

The "Laid Back"

Unlike the "success seekers", the "laid back" (16 percent) don't see being rich as a definition of success, rather, they're preoccupied with living better than others. They have little interest in premium, branded or high-tech goods and they don't suffer the same stressed outlook as their counterparts.

The "Spendthrifts"

We also identified a smaller but nevertheless distinct segment, representing 10 percent of the overall post-90s group, whose materialism and lax attitude toward their future makes them a valuable consumer group.

They grew up in households where all their material needs were covered for by their parents and, today, as they embark on their careers and start to earn their own livelihoods, they appear to be carrying the relative disregard for saving money into their current spending habits. These well-educated, high earners are the most willing segment among the post-90s generation to spend money on the latest fashions, top brands and leisure activities in order to stand out from the crowd.

The "Homebirds"

The smallest segment of the post-90s generation, making up 8 percent of those surveyed, is what we've identified as "the homebirds" – those yet to have flown the nest and who still rely on their parents, especially for big ticket items. This low- income, predominantly female (68 percent), segment want to lead their own life, define success as living better than others, and feel little stress about their present situation or the future.

However, since they have not yet achieved financial independence, and given their comparatively gloomy outlook toward their earning potential—only 38 percent believe their household income will significantly increase in the next five years, compared with 53 percent overall – the "homebirds" are most likely to save for a rainy day.

Key takeaways

The post-90s generation represents a promising group of consumers who will heavily influence how brands perform in China.

However, brands should learn to manage their portfolios with new and emerging consumer segments in mind. Each segment differs and they differ again to western millennials.

Companies that think carefully about their story and whether it will resonate with these segments based on their beliefs and attitudes will have an advantage. Understanding the specific motivations of each post-90s sub-set will help companies to tailor their marketing messaging for more targeted reach.

While higher tier cities remain the focus, companies should pay close attention to populations of young people in lower tier cities and rural areas, where they exist in large quantities. They're optimistic about their future spending power and there is significant opportunity for companies to enter these markets early with the help of ecommerce.

Double-click: Gaming your worries away

It's no secret that social media is key to winning the hearts and minds of younger consumers. Tencent's multi-player mobile game, Honor of Kings, has successfully targeted the two largest post-90s segments – the "happiness seekers" and the "success seekers" – by appealing to their unique motivations. For the "happiness seekers", the game appeals to their desire for happiness and quality of life. For the "success seekers", it serves as an outlet for escaping their stressful existence.

Trend #4: Chinese consumers are taking a more nuanced view of brands, both global and local

In past surveys, we saw Chinese consumers take a strong interest in international brands. In other years, they acquired an interest in local brands. In recent years, they have developed a sharp eye for brands that delivered value for money.

In this year's survey, we've observed consumers take a more nuanced view of the brands they choose.

Across the majority of categories surveyed, brand origin matters less than before. Consumers today have very clear expectations and they apply to local and foreign brands alike. First and foremost, they want value for money. That's followed by quality products – they want their unique tastes catered to - and, lastly, they demand good after sales service.

In 8 of the 17 categories surveyed, respondents showed clear preference for local brands because they deliver in these three areas. Combined, these categories account for more than half of the total retail sales in China. (Exhibit 5)

In many cases, Chinese brands have become credible competitors. This is especially true in the personal digital gadget and personal care categories, where they have cemented their position over the last five years.

In 2012, Chinese brands accounted for 43 percent of the market in categories such as personal digital gadgets versus 63 percent in 2017. In personal care, Chinese brands made up 76 percent in 2017 compared with 61 percent in 2012.

While the survey showed that brand origin matters less than before, it also highlighted a level of confusion among consumers; there is increasing ambiguity between the country of origin and the country of manufacture.

It's fair to say, then, that Chinese consumers buy local brands not because they're local but because they believe they offer better value, the product is more suitable for them, and that the service is superior.

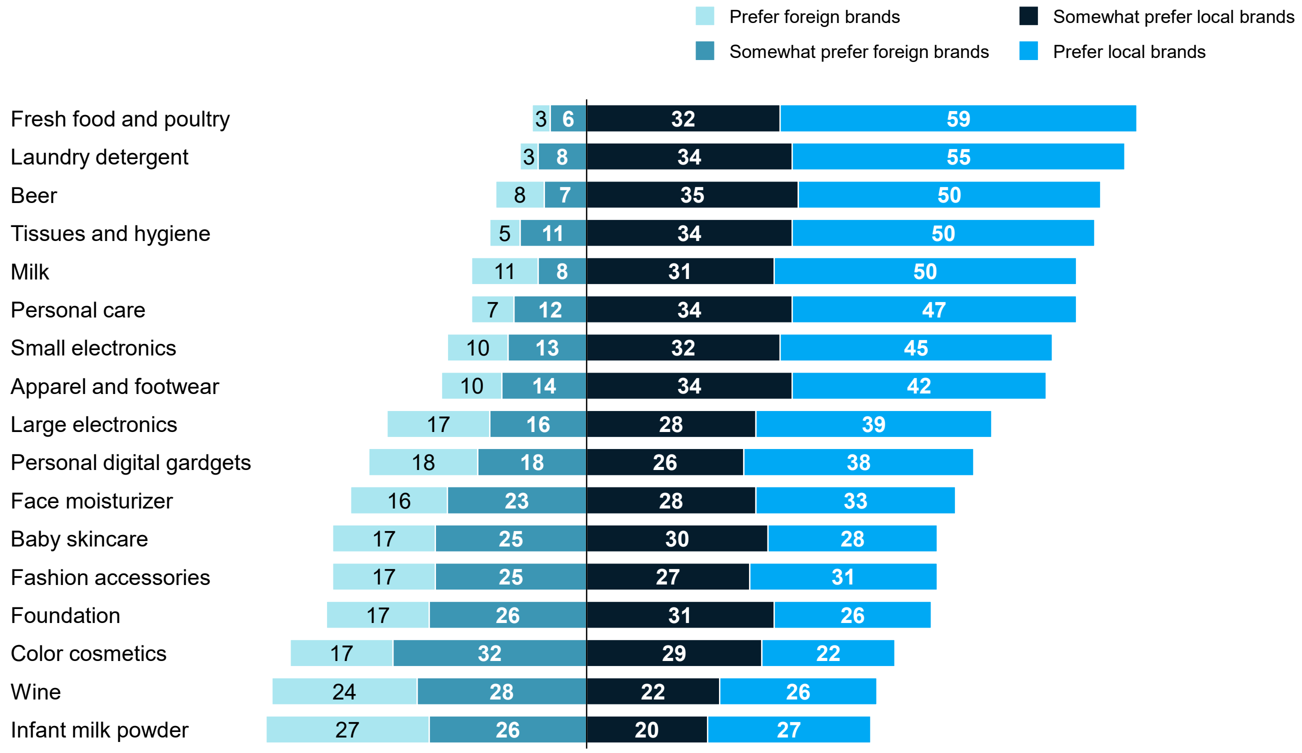
In the remaining six categories, there is no clear preference for foreign or local brands. However, in the instances where foreign brands are preferred–namely cosmetics, wine, and infant milk powder–demand for better quality and well-known brands emerged as the key factors in consumer decision making.

Across these six categories, 64 percent said they would seek out and pay more for better quality products that last longer while 46 percent would buy internationally branded products if they had more money. More than half believe well-known brands are always of better quality.

Exhiti 5

Consumers are taking a more nuanced view of brands

% of survey respondents



SOURCE: McKinsey China 2017 consumer survey

Double-click: Brands beyond borders

Chinese outbound travel has negatively affected consumers' perception of brands in China among 30 percent of those surveyed. The top complaint from these well-travelled shoppers is that Chinese brands are of poorer quality (48 percent) and present a less premium brand image (39 percent). However, they also said that discrepancies over quality (40 percent) and after-sales service (40 percent) impacted their view of foreign brands in China. Brands should take such dissatisfaction as an early warning sign: more than half of these consumers were born after 1980 and they show a willingness to pay higher prices. They will become a valuable, and profitable, consumer segment.

Blurring between local and foreign

However, as with the health-conscious consumers described earlier, a mismatch exists between perception and reality when it comes to brand selection.

Many believe that global brands with a longstanding presence in China, such as Olay and Biore, are local brands . In the yogurt category, 45 percent of consumers believe Danone, which originates from France, is a Chinese brand and 48 percent think the same of Yakult, which is from Japan. On the other hand, Chinese brands that have packaged themselves as international are often mistaken as foreign. Beingmate (infant milk powder) is regarded as a foreign brand by 45 percent of respondents, and, in the apparel category, where 76 percent of consumers prefer Chinese brands, Shanghai-based casualwear brand, Metersbonwe, is thought to be foreign by 45 percent of consumers. (Exhibit 6)

Key takeaways

Both foreign and local brands have opportunities to grow in China providing they can appeal to the increasingly nuanced needs of consumers.

MNCs may find it easier to invest in new products and strategies that bridge the gap in areas where local companies are currently preferred, including pricing, quality and service.

For local brands, catching up with foreign brands on their attributes - safety and aspirational qualities - will be more challenging. Joint ventures and M&A may support their growth strategies in such cases.

Conclusion

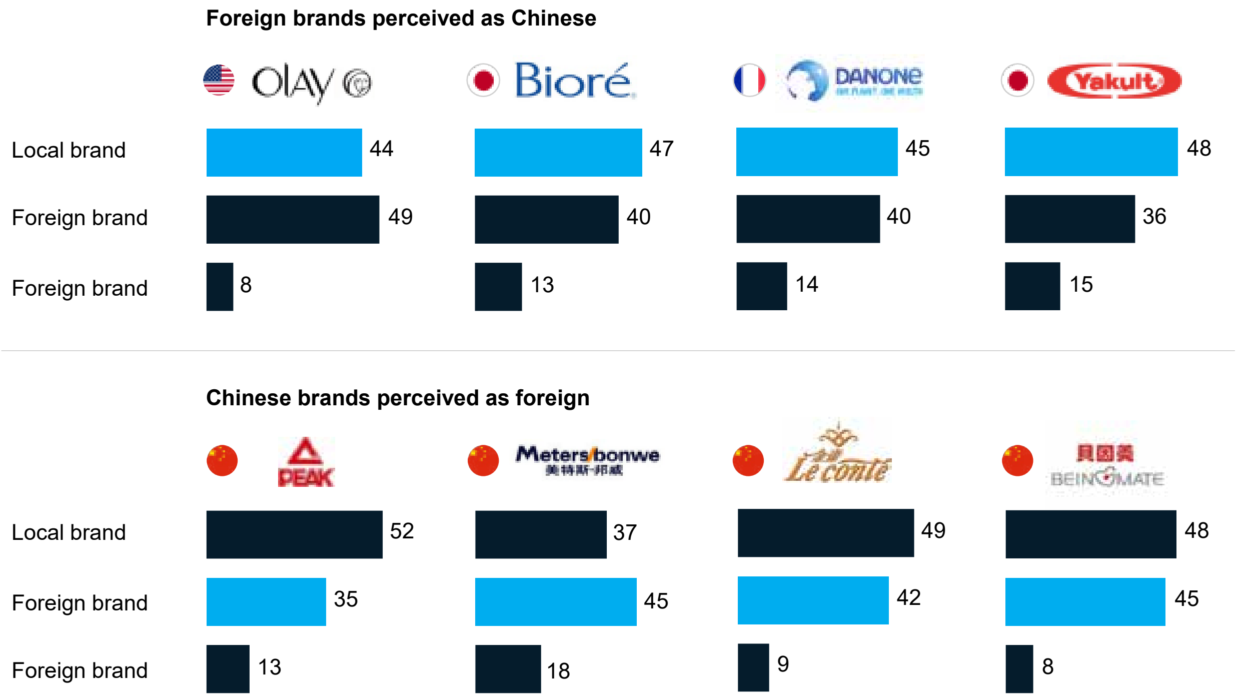
There is no longer a single, one-size-fits-all definition of the Chinese consumer.

These increasingly discerning shoppers are younger, focused on health, and more brand savvy than ever, and they demand more from the products and services they buy. Both global and local companies must understand these nuances if they hope to craft brand and product messages that appeal to them.

Exiti 6

Perceived country of origin of select brands

% of survey respondents



SOURCE: McKinsey China 2017 consumer survey

Double-click: The value of value

Cost is less of a concern among today's consumers who appear to be preoccupied by value for money. Huawei is a good example. The Chinese technology company is top of mind among consumers who are proud to own a Chinese smartphone that is as attractive and technologically advanced but less expensive than an iPhone.

Conversely, consumers are also willing to pay a premium for top of the range foreign brands that they believe offer great functionality, design, and quality. Take British technology firm Dyson, for example. It saw Chinese sales grow by more than 200 percent in 2016, despite its products costing considerably more than the local alternatives.

About the McKinsey 2017 China Consumer Survey

Our study combined a comprehensive survey of Chinese consumers, in-depth research, and observations from our work advising companies in China.

— The survey was conducted from May to July 2017, and is part of a series of comprehensive surveys of Chinese consumer behavior conducted by McKinsey since 2005.

— The survey sample included approximately 10,000 respondents from 44 cities and 7 rural areas, representing approximately 90 percent of China's GDP and more than half of its population.

— We conducted a combination of online and offline research with respondents, covering consumers' general attitudes and purchasing behavior, key trends regarding their consumption patterns and leisure habits, and attitudes toward life, success, money, and health.

— The survey included a deep dive into apparel, cosmetics, and fast moving consumer goods categories, including food, personal care, and household products.

— Our research was supplemented by additional research that McKinsey is conducting on consumer sentiment in 26 countries. Results from our 2018

— Global Sentiment Survey are available on mckinsey.com.

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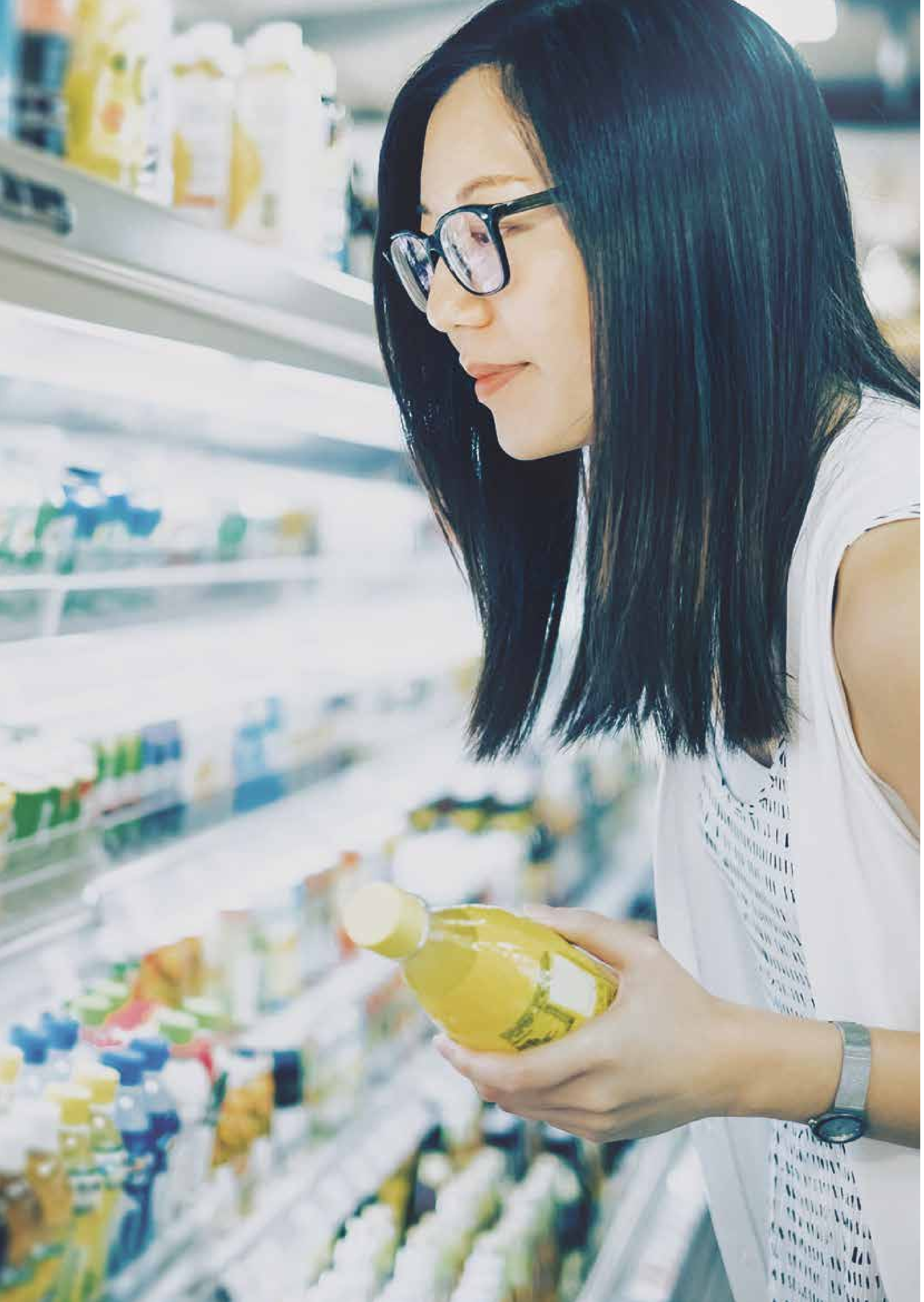


Reviving grocery retail: Six imperatives

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

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 channels[1] 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

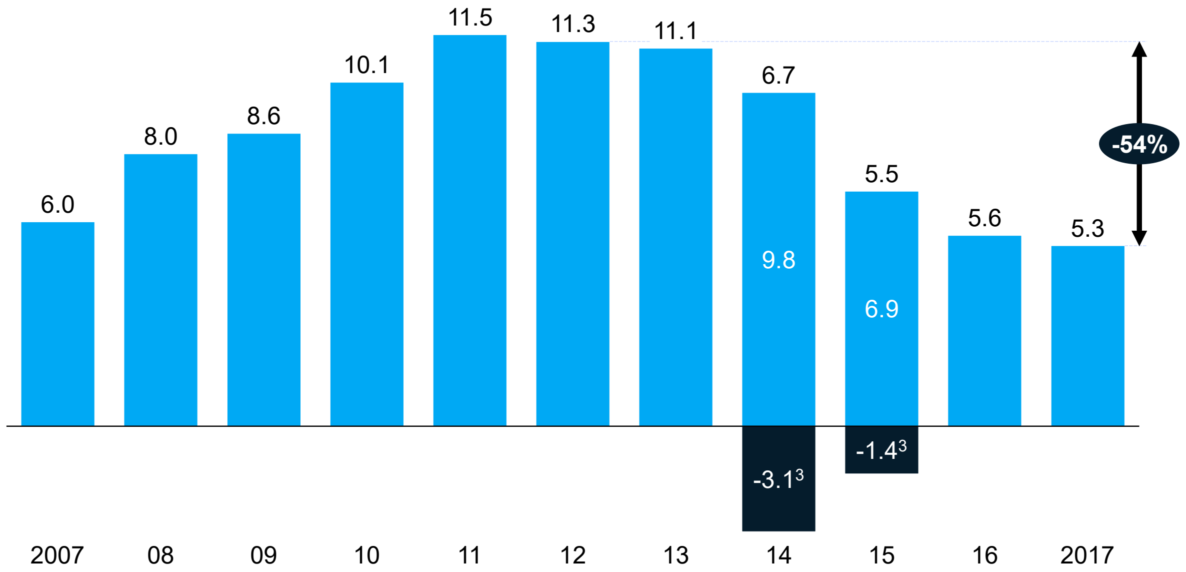
In the past decade, sales growth among large grocery chains in the mature markets of North America and Western Europe has been a pallid 2 percent (compared with 9.8 percent in Africa, 8.4 percent in Eastern Europe and South America, and 6.2 percent in Asia). Even that 2 percent growth has been hard won.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

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.

Exbiti 1

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

Economic value add[1] 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

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, any where, 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 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 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.

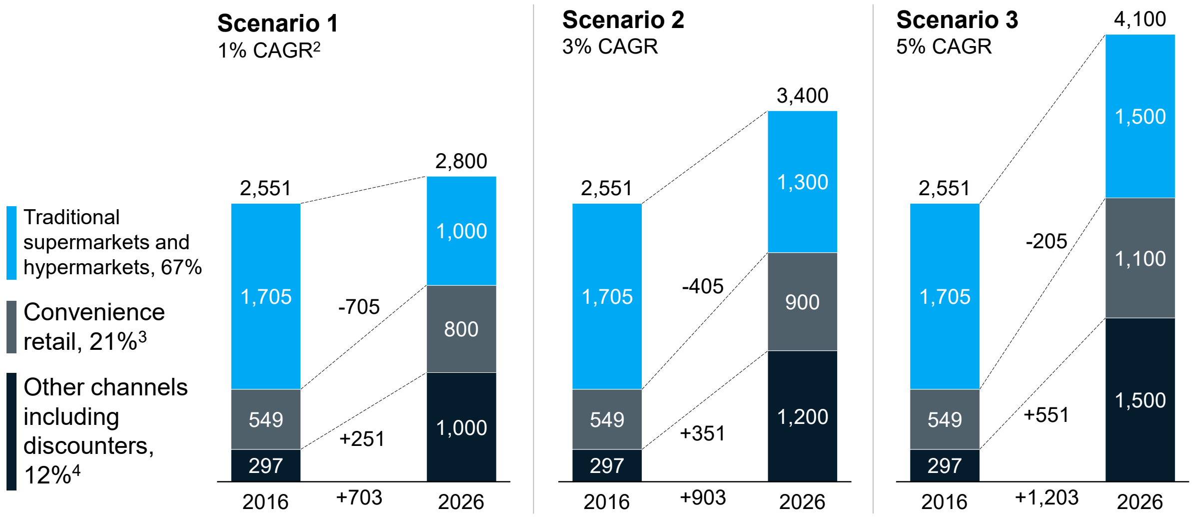
Indeed, ecosystems are emerging around the world and generating much of the growth in e-commerce. In China, Alibaba aims to seamlessly integrate online and off line channels; it calls its ecosystem "New Retail." Data-driven personalization, as well as network and scale effects, drive down ecosystems' 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).

Exbiti 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, off line 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. W hat are the potential disruptions? W hat 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.

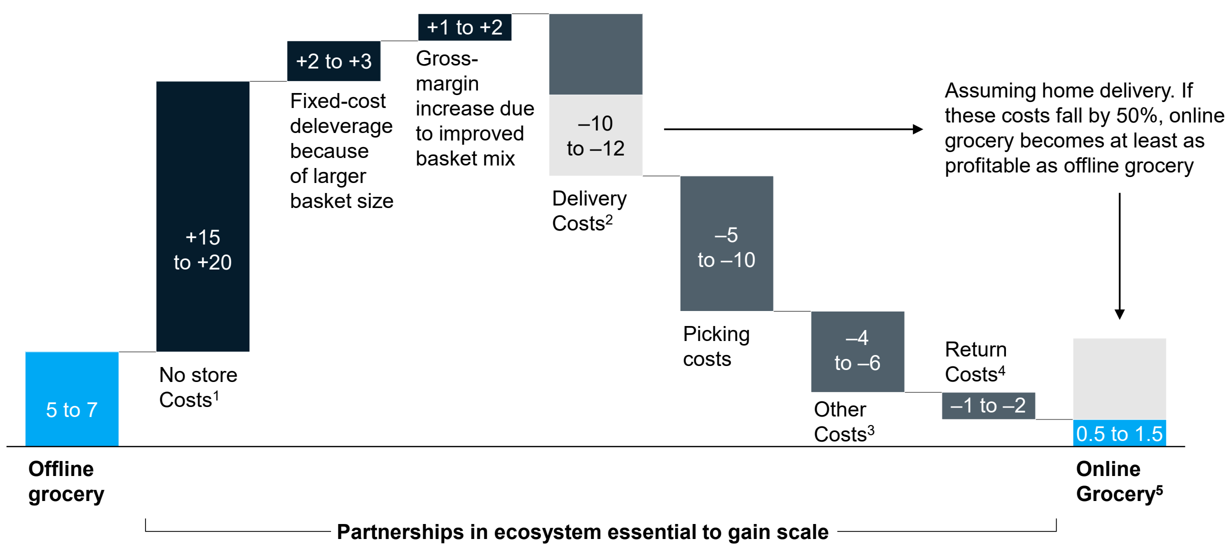
Another potential solution is pooled deliveries, which would require grocers to collaborate with their competitors or with other businesses: for example, one player or a third-party logistics provider could combine several retailers' deliveries. In China, about 50 companies have been piloting an app 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.

Exbiti 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 o.ine sales

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

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 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?

— 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 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.

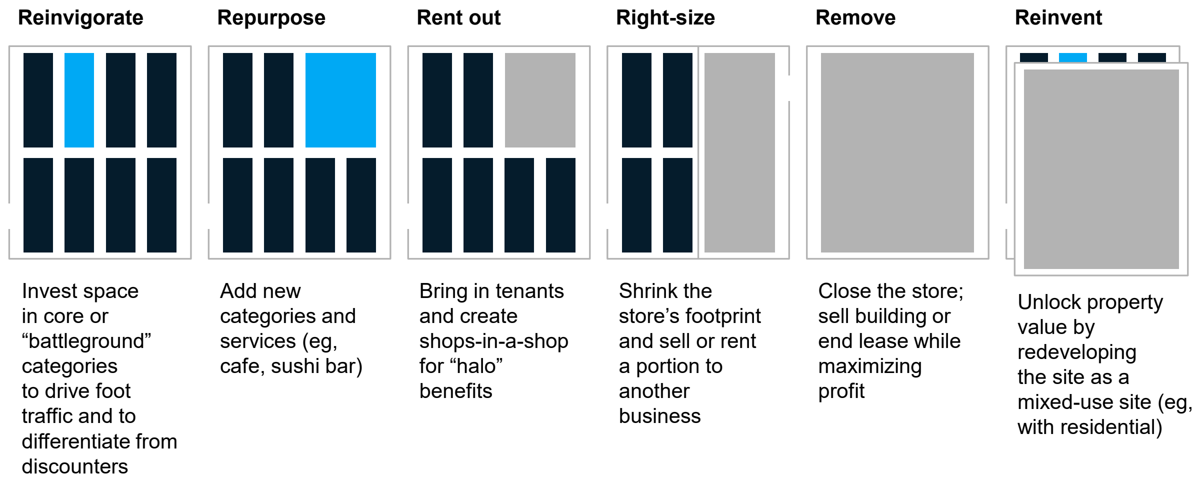
6. Innovate ten times faster

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.

Exbiti 4

Grocers can address overcapacity in a number of ways

Potential levers for addressing real-estate challenges



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

Exiti 5

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

Inception Day 2	Day 2	Day 4	Day 8	Day 10	Day 13	Day 16	Day 20	After approval
Initial concept direction (business objective)	Conducted 50 user interviews to assess shopping journey	Created customer segments and journeys, selected target customer	Developed and designed digitally enabled shopping concept	Conducted 20+ user tests on target customers to refine concept	Designed technical solution and high level IT architecture	Created and validated business case and investment road map	Refined and implemented road map, developed investment proposal	Technical proof of concept in lab environment

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

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

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Tech in (food) retail: 70 percent change man-agement, 30 percent tech

Gemma D'Auria, Alejandro Diaz, Karel Dörner, Jop Gerritsen, and Dymfke Kuijpers

Why tech matters

Everyone in retail is talking about becoming tech-nology enabled—e-commerce is beyond its tipping point, large-scale tech players are moving in and disrupting the industry, specific tech-enabled use cases are starting to deliver profit-and-loss (P&L) impact, and more than 50 percent of retail activities can, in theory, be automated.[1]

Tech status today

Despite lots of buzz in the industry, traditional food retailers have yet to transform themselves into true data-driven and tech-enabled organizations. New retail players and pure players are leading the way with early signs of success (especially in China).

Why is it so hard to get this transformation going? We see certain traditional retailers demonstrating pockets of excellence: in personalization (for example, Kroger, Loblaws, and Tesco), data-driven merchandising (most global leaders), advanced forecasting, auto-mated replenishment (Walmart), and experiments in seamless checkouts (Ahold Delhaize, Walmart). The reason is not that traditional retailers lack the data or customer insights, nor that they face legacy issues in their systems. These elements do not help, but you can work around them in the short term to get impact, while modularizing and modernizing your IT archi-tecture in the background. The real issue is traditional DNA standing in the way of change.

[1] Michael Chui, James Manyika, and Mehdi Miremadi, "Where machines could replace humans—and where they can't (yet)," McKinsey Global Institute, July 2016, McKinsey.com.

Traditional DNA standing in the way of change

Traditional retailers have made a living in the last 100 to 150 years by perfecting their execution machine to cater to many stores. Their DNA is fundamentally different from new retail players:

— **Compromise is acceptable.** Contrary to new retail players that preach "unreasonably high" standards[2] and have an endless aisle, traditional retailers are a historical by-product of compromise. The traditional box is a compromise of service and experience, a curated assortment (as not all assortment physically fits in the store), available locations, and value for money (reasonable is good enough, lack of transparency in full value offer). "Meeting the bar" on a few dimensions and excelling only in one or two elements was the recipe for success. Alibaba and Amazon, not tied to the limitations of a physical store, have broken that mold with their triple threat: better customer experience, better offers, and lower costs.

— **Data and tech capabilities are noncore.** Retailers have a long history of outsourcing "noncore" func-tions—whether in the back office, IT, or analytics. The heroes of these companies were, for a long time, the category managers and store managers, where entrepreneurship and commercial creativity have been historically celebrated. Many of these he-roes are now in executive teams. Retailers that have franchisees, especially, know the value of a local entrepreneurial shop owner running a P&L. Data and tech capabilities have not been built internally but rather outsourced, to Dunnhumby or Symphony EYC and the like. Prioritization of use cases is often done by federation, by IT, or even worse, by vendors. Traditional retailers are now massively shifting gears but struggling. The difference between a good and a bad coder is a factor of ten; but it takes an excellent one to spot a good one, and a different environment to excite an excellent one to come work with you. Based on web scraping, we found selected pure players have more than 25 percent of their own staff with an analytics or tech background.

— **Tech is a cost, not a revenue.** Retailers have a long, good tradition of saving to invest in their customers. Saving for cus-tomers means reducing overhead in favor of lower prices and better service, for instance. However, IT is considered part of overhead. In contrast, pure players see IT as a competitive weapon—they invest five to ten times more, thereby outspending and outcompeting traditional retailers. They prioritize IT initiatives based on what matters most to the customer.

— **'Do not experiment, do not fail' has been the formula for success.** Retailers have specialized in functional excellence, focusing their people on cat-egory management, supply chain, store operations, and support. Each functional silo has perfected its processes, with a clear handover to other functions. Daily operational excellence is key: offer changes need to be integrated into the distribution network, so that they can be rolled out to hundreds or thousands of stores and fit with company-wide pricing rules. A five-year-out vision, trial and error, and a learning loop are not in the DNA; instead, milestones are carefully planned and managed to ensure that the system is able to implement.

[2] Jeff Bezos, Annual shareholder statement, April 2018, sec.gov.

How to make it happen

Based on working with many companies globally, we see the following elements as being critical:

— **Set 'unreasonable' standards.** To break the compromise culture, the CEO must set "unreasonable" standards. Jeff Bezos, in his annual shareholder letter, explains how customers are continually and unreasonably increasing their expectations. To meet these expectations, as a CEO, you need to demand unreasonable customer stand-ards, unreasonable innovation-speed standards, and unreasonable quality standards. Best-practice ex-amples include Alibaba, Amazon, Apple, Google, Tesla, and Zappos, as well as local champions such as Coolblue and Ocado.

— **Careful selection of where to play.** As ecosystems emerge locally, retailers need to decide which battlegrounds to win, and which resulting digital and analytics "use cases" to master. This requires a deeper understanding of potential customer habits, potential competition, and po-tential tech five years out. Nobody has a crystal ball, but you need to think through how potential disruptions can inf luence service standards as well as profit pools. This requires a clear mandate from the top, with an aligned road map and business case, balancing today with tomorrow. It requires making choices: food versus nonfood, payments, the customer interface, service op-tions, and how to deliver the last mile. It requires choices as to which partners will complement you in an ecosystem, with the goal of creating a virtuous cycle of using data to get closer to the customer, and radically reducing the total costs of the system by bringing together people, com-modities, and venues. Best-practice examples include Amazon, Ping An, and Tencent, as well as players like Deliveroo, Instacart, Ocado, Walmart, and Wegmans—players that have defined their role in the ecosystem, and some, such as Walmart, purposefully using acquisitions to fill gaps.

— **Invest in the right mix of wizards and translators.** To manage your company, new skills are needed in data science, IT architecture, software engineering, and user-experience design. You need to figure out—based on your use cases—how many you need. Se-lecting the right partners is crucial, but critical skills (product owners, lead data scientist, architects, and lead engineers) need to be in-house. In addition, enough translators need to be recruited and upskilled in-house. Translators are people in the business (such as category managers, store and regional managers) who understand data and tech suffi-ciently to know how to extract business value from tech and analytics. Contrary to common belief, the wizards are not the bottleneck; it is true that they are hard to find, but with some effort in creating the right tech careers, an empowered environment, and "real appreciation for geeks," you can. The real bottleneck is upskilling your entire organization to ensure insights are translated into action by the front line. You need ten translators for every wizard to make this happen. There is no silver bullet when it comes to the optimal mix of in-house resources versus partners, and it changes over time. At the start, you will likely have too many external delivery resources. In the end state, however, you will likely have a balance of the lead tech and data skills that you will need, for example, to manage your partners and maintain company standards; an adequate level of generalist engineering and data-science capacity (for rapid development and testing); ex-pert partner resources located in-house that can scale up or down with use cases; as well as mature, commoditized, and specialized skills offshored or outsourced.

There is one golden rule: own your own data. You can, however, have others analyze parts of it for you—if you set the standards and governance, and know what they are doing. Most traditional players are in the middle of a transformation, and none are best practice yet. Insourcing is the game, as demonstrated by Kroger, and more recently, by Sainsbury's acquiring Nectar from Aimia. Companies like Majid Al Futtaim, Media-Saturn, Pizza Hut, and Telefónica are reskilling their entire organizations, from top management to the front line.

— **‘Use-case-back’ data and tech-stack de-velopment, fit for rapid scalability.** Most retailers have monolithic legacy systems. They need to decouple and modularize the architec-ture, set up new tools, structure, and ingest new data. This requires strong architects who understand where to bypass and where to depend on the old systems. Data engineers need to clean up the data structure. These efforts need to be linked to a road map that prioritizes use cases of time. Any data or tech strategy should always be in func-tion of the business aspirations. Data cleaning for the sake of data cleaning is a waste of time. Most traditional retailers have a form of a data lake. However, we often come across state-of-the-art data lakes that are shallow, with tools that are not used. In contrast, retailers using a use-case-back approach show early successes, es-pecially in supply chain, merchandising, and personalization. A use-case- back approach starts with the definition of the value that the use of data and tech will deliver, to the customer, the user, and the P&L. It then outlines what data (and tech) you need, before moving into modeling, underlying systems, and required change management to drive adoption. For inspiration look at Kroger, Media-Saturn, and Woolworths.

— **Work cross-functionally and fail fast.** Success requires a radical move toward small, cross-functional teams that have a common purpose and set of key performance indicators, work in two-week cycles, put the customer at the center, and continuously test and refine their products. To make this stick, you need to educate your organization, starting with the executive team. Some retail CEOs get it—they set a high bar, walk the talk, train tens of thousands in the new cross- functional way of working, and foster a test-and- learn mind-set. Others keep discussing PowerPoint presentations on “what it takes to be agile,” or they limit the new way of working to limited pockets of the organization. Microsoft is a company that has been successfully driving a “fail fast” culture; ING, Netflix, and Spotify have embraced agile. This requires a change in your DNA.

— **Decide on your big moves.** To outperform others, you need to place your bets. Are you fully innovating your business model, or just using analytics to improve the per-formance of your existing business? Are you going to disproportionally allocate capital toward new use cases and innovation? Are you tightening up on productivity in your core business to free up the cash to do so? Are you using programmatic M&A to acquire missing capabilities or assets to strengthen your aspired role in the ecosystem? In other words, what are the big moves that you are willing to make? (And which moves will you not make?) Walmart is one of the best examples of a traditional retailer that uses programmatic M&A to drive its transformation, for example, with the acquisitions of Flipkart.com and Jet.com, among others.

Getting started

Getting started is often the most challenging part of any transformation. There are a few considera-tions to think through:

— **Dream big, start small, scale fast.** Have a big aspiration that inspires the organization to change. Start small to show early wins. Scale fast to keep momentum across the company.

— **Decide on the governance of ‘run versus change’ (or ‘today versus ...tomorrow’).** With most retailers run by weekly sales numbers, freeing up time to transform the core is hard. Several retailers are in various stages of putting in place a “center of excellence” to boost ca-pabilities.

— **Build, operate, and transfer to build speed.** Without jeopardizing the existing business, scale up and build capabilities internally. Careful selection of a small set of strategic partners that are truly incentivized for impact, building capabilities, and changing behaviors will be crucial to becoming independent and making fast progress.

— **Just get started.** Set up a team as a change engine. Take four to six weeks to shape the aspiration and use-case road map, four weeks to outline the first one or two use-case concept sprints, six to eight weeks to deliver a proof of concept, and three months to launch a minimum viable product. Scale back on the first proof point to meet this timeline, and iterate toward the highest standards.

— **Focus on impact.** Your first use cases need to relentlessly focus on the customer and also deliver bottom-line impact, so that you can invest back in capability building and the next use cases. Transforming into a tech-enabled company creates value—and should do so from the start.

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How analytics and digital will drive next-generation retail merchandising

As merchandising in retail continues to evolve with the integration of analytics and other digital solutions, merchants need to become much more nimble and ready to fulfill customer needs.

Steven Begley, Rich Fox, Gautam Lunawat, and Ian MacKenzie

There is no denying that the retail landscape is undergoing a revolution unparalleled in recent memory. The pace of change continues to accelerate, driven by increasingly sav vier and more demanding consumers as well as shortening product and trend life cycles, making it increasingly challenging for retailers to keep up. All the while, traditional avenues for growth through brick-and-mortar expansion are drying up, and newer forms of growth, such as online retail, localized assortment, and expansion into international markets, are more competitive than ever.

Against this backdrop, the historical core of every retail organization—namely, the merchandising function—is finding itself at a critical inf lection point. Over the past few years, the role and scope of the merchant has been forced to evolve rapidly. Endless-aisle assortment now provides more breadth and depth of products than ever before. With the rise of omnichannel sales, merchants must deliver a more interconnected shopping experience. To get product to customers quickly, merchants are working with cross-functional colleagues to increase vertical integration and with third-party partnerships to speed up and boost the supply chain. In today's faster-paced, more complex environment, these adjustments have allowed merchants to become more nimble and adaptive to consumer trends while they pursue the goal of presenting a seamless, omnichannel customer experience.

That said, winning decisions are increasingly driven by analytics more than instinct, experience, or merchant "art"; what succeeded in the past is now a poor predictor of the future, and analytics is helping to inform and unlock new pockets of growth. By leveraging smarter tools—those beyond backward- looking, "hindsighting" analysis—retailers can increasingly make forward-looking predictions that are no longer considered advanced but quickly becoming the "table stakes" necessary to keep up. Despite recent progress, most (if not all) leading retailers recognize the need to develop next- generation merchants to drive their business in this new world.

Indeed, retailers need nimbler merchants who leverage automated technology solutions to support decision making, have a more strategic mind-set with a focus on proactive category management, and who allocate more mindshare to the customer to create a truly personalized and distinctive shopping experience. However, several challenges in building this vision plague many retailers: talented merchants adopt traditional mind-sets that limit the ability to evolve, legacy technology systems hinder the ability of merchants to reach the better decisions they desire, and limited time and mindshare leave many merchants stuck focusing on day-to-day execution.

In this article, we lay out a vision for the next-generation merchant many retailers need, and we address the common questions that naturally arise when thinking about how to bring this vision to life.

Supporting next-generation merchants

Complexity has driven inefficiencies in today's merchandising organizations, where the burden of low-value-added work is quite high. Case in point: in a recent McKinsey survey of more than 30 retailers, we found that merchants spent approximately two-thirds of their time gathering data, managing exceptions, "firefighting," and participating in meetings to syndicate with colleagues and only one-third of their time working on critical strategy and analytics or insights. Ultimately, we believe four key principles will underpin the next-generation merchant and lead to increased efficiency and effectiveness within the broader merchandising organization.

Merchants are the backbone

Merchants will operate like a "category owner" and lead a cross-functional team, as the role will evolve to be more strategic to free up capacity for new avenues of growth (Exhibit 1). We believe that with a three- to five-year time horizon, the primary responsibilities within merchandising, such as assortment, planning, and negotiation, will remain core to the role. Furthermore, the fundamental decisions made as part of this evolution, such as what the price of a product should be, will also remain. However, the automation of insights is expected to have a meaningful impact on the way a merchant works, how decisions are made, and what new capabilities will be required.

The automation of insights is expected to have a mean-ingful impact on the way a merchant works, how deci-sions are made, and what new capabilities will be re-quired.

Exbiti 1

Merchants are evolving from quarterbacks to 'category owners

Merchants have classically been described as quarterbacks	manager and -owner traits, becoming category owners
Running structured playbook around standard product or seasonal calendar	Using agile practices to respond rapidly to changes in business
Coordinating multiple teams	Partnering with subject-matter experts and relying on experts to deliver answers on solution pieces
Driving toward specic outcomes	Investing in overall performance and making appropriate trade-offs to get there
Solving business problems	Helping others solve their own problems by clearing organizational roadblocks
Focusing on specic categories and channels	Taking customer-back view of holistic experience that delivers on overall company strategy

We believe that many of the core merchandising responsibilities at leading retailers could be almost entirely automated in the near future (many retailers have already started this journey). For example, the reactive nature of many replenishment actions will transition to proactive mitigation, leveraging better decision models and algorithms that move inventory and reduce opportunity cost. Time spent developing manual planning reports can be offset with automated predictive analytics. The typically tedious practice of drawing planograms across different store formats and f loor plans can be swapped for smart planograms that adjust for microsegments, which will enable faster and more granular inventory management.

While some responsibilities, such as negotiations and sourcing, will continue to require a meaningful human touch, they can still be heavily supported with standardized tools and approaches backed by insights based on internal and external data points and real-time analytics to optimize decisions (Exhibit 2).

In line with these changes, retailers will be forced to assess the capabilities required to be a successful merchant and the changes needed within their talent pools. W hile automation will guide merchants to insights more quickly, it will place an even higher emphasis on their ability to interpret insights and implement them to achieve their objectives. This will take analytics capabilities, critical problem-solving skills, and a shift to a proactive, forward-facing mind-set.

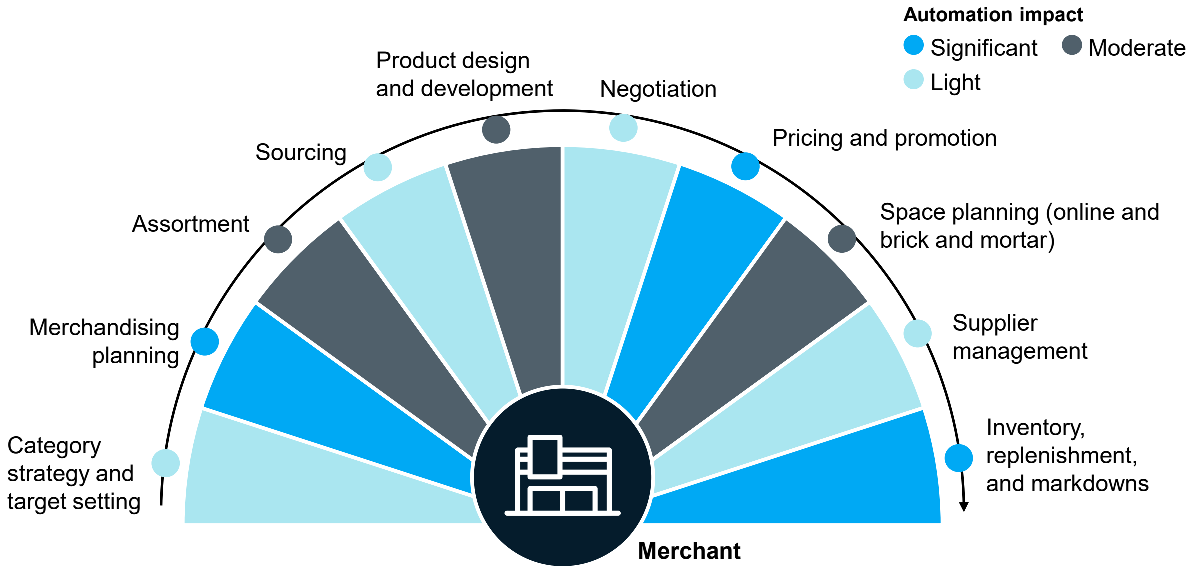
Customer-focused approaches are critical

A seamless, customer-centric, omnichannel approach will be key to engaging customers across multiple formats. Retailers will need to ground their approach using a customer lens. As shoppers increasingly f luctuate among channels, retailers must find ways to ensure that different functions and business units work together toward a more seamless customer experience. Customers expect consistency across channels but understand and appreciate variation when there is a rationale— for example, when customers expect a broader assortment from e-commerce channels.

Exhiti 2

Automation will have an impact on most elements of the merchant role

Core merchandising activities



Technology enablers

- System architecture
- Data-quality and -governance management
- Advanced analytics
- Tracking and learning
- Automated workflows
- Digital visualization

There is no single "right" approach to organizational structure, but we see the following three typical archetypes for how retailers set up their organizations at a global level to support the omnichannel experience:

— standalone e-commerce unit (common starting point)

— semi-integrated e-commerce with a center of excellence (most common in ramp-up)

— fully integrated e-commerce in business (more mature companies operate here, although they often retain e-commerce and digital- product teams, such as those for apps and websites)

Leaders show architected differentiation across their channels to create a complete merchandising offer. They might use the following approaches:

— add long-tail products (such as sizes and special-purpose products) to capture fragmented demand where economical

— exclude some iconic items online (in other words, have a smaller assortment online) to drive footfall to stores

— push items at the end of their life cycles out of stores for space or new-drop reasons (in other words, have a larger assortment online) to drive incremental full-price sales

Omnichannel leaders are using highly consistent visual merchandising, such as consistent in-store and online themes, to keep the brand message and story clear across channels. Furthermore, the online space—including third-party platforms and marketplaces—is an increasingly important channel for clearance and low-volume SKUs because of its pleasant, convenient experience, lack of space constraints, and high ease of flexibility in executing markdowns.

Systems and tools need increased attention

Systems and tools will become more critical in the day-to-day tasks of retail merchandising. As complexity and pace increase, merchants will find it harder to rely on the Band-Aid solutions they have used. Instead, more sophisticated solutions that streamline the ability to develop insights will help merchants focus on the most important strategic priorities rather than the most pressing "fire drill" (Exhibit 3).

Technology improvement is necessary

Foundational and core technologies will need enhancement to support the advanced analytics and insights-driven approach necessary for next-generation merchandising work. Organizations will need to invest in the following four key foundational capabilities to empower the merchants:

— **Flexible, modular system architecture.** This system model will allow various layers to operate in a decoupled fashion through the extensive use of application programming interfaces and microservices.

Exhiti 3

As merchants manage a more complex set of decisions, more automated, efficient systems are becoming critical

Examples of future requirements

Category strategy and target setting
Consolidate set of internal and external insights from the previous year that automatically provide recommendations for next year's performance to guide merchant's top-down business plans

Planning
Automated historical analytics and predictive scenario analysis embedded in advanced planning system

Assortment
Recommendation engine that suggests changes by item and links to category strategy (eg, evaluates Incremental sales by SKU, substitutability and transference, and consumer insights)

Sourcing
Integrated line-review tools to enable cross functional collaboration (eg, vendor vetting, merchandising, and design)

Product design and development
Increased use of automation to clean-sheet product design and guide "design to value" decisions and insights

Negotiation
Automated negotiation playbooks with direct data feeds to data systems and prepopulated insights for automated visualization of current and historical vendor performance across category and assisted negotiation strategies

Pricing and promotion
Predictive impact analytics integrated into dynamic pricing/ markdown system, with web scraping, to inform retail trends

Space planning
Merchant-led planogram capability with automated, assisted drawing with real-time advice tailored to local demands

Supplier management
Automated supplier portal and dynamic purchase-order management system

Inventory, replenishment, and markdowns
Automated predictive inventory optimization and forecasting tools that trigger alerts, prioritize actions based on key performance indicators, and recommend supplier communications

- **Deeper data-governance, quality-control, and data-management capabilities.** Enabling merchants to make data-driven decisions will start with the use of a well-established data- governance model that includes data access, ownership, and classification. The model will be owned by the merchandising business units and supported by “data stewards” from the IT and business teams. The data-management capabilities must support big data processing and storage through next-generation data warehouses, data lakes, and distributed, often cloud-based, data platforms. At the same time, data quality must be tracked by key performance indicators, with clear cleaning protocols established.
- **Computational capabilities, such as advanced analytics and machine-learning models.** New proficiencies that enable automated predictive and prescriptive analyses based on market, finance, and customer data will drive better, faster decisions and ac-tions. These should be coupled with monitoring and feedback mechanisms to create a con-tinuous- improvement loop across all actions, which will enhance machine-learning models with time.
- **User-journey capabilities.** Enable consistent visualization standards for the mer-chant interface and experience, and utilize work f low– management tools, optical character recognition, and robotic process automation to streamline work.

Encouraging organizational success

To build tomorrow ’s merchandising organization, retailers will need to become more agile, digitally enabled, and rooted in advanced analytics. This should not come as a surprise to most readers; the question is how to build a culture and performance-management system that promotes these changes. We have recently worked with clients to support their rapidly changing merchandising functions and have learned several key lessons along the way. We believe that a set of organizational enablers will support the next-generation merchant (Exhibit 4).

Exbiti 4

Organizational enablers will be critical to setting up next-generation merchants for success

Digital-talent management

Talent quality:
Do employees possess sufficient digital expertise to meet business-unit requirements?

Recruiting:
Which recruiting approaches are used to win top digital talent?

Value proposition:
Is there a convincing value proposition to attract and retain digital talent?

Digital culture

Risk culture:
To what extent does the organization support risk taking and experimenting with new ideas?

Leadership style:
How do managers lead employees and teams?

Vision and values:
To what extent is the organization driven by a common vision, values, and team spirit?

External networks and partnerships

Partnerships:
Are there systematic partnerships with digital vendors and leaders to complement the organization’s digital capabilities?

Expert networks:
To what extent do employees possess relationships to relevant external communities?

Key performance indicator (KPI)-based steering

Measurement and communication:
Are digital KPIs (eg, trafc, usage, digital revenues) defined, measured, and transparently communicated?

Steering:
Do digital KPIs have clear, tracked targets that drive product adjustments?

Performance culture:
How open and transparent is the organization regarding employee performance? What are the incentives for performance?

Performance management

Continuous improvement culture:
Does the organizational culture support continuous improvement and development? How are new ideas and critiques received?

Collaboration and process automation:
To what extent are digital tools used to share, coordinate, and streamline work?

First, there is a critical need for digital-talent management, including talent quality, recruiting, and value proposition, to attract strategic merchants with broad, deep skills that extend into the digital and analytics domains. Married to this talent management is talent retention. Retailers must ensure they have well-rounded performance- management methods, such as a continuous- improvement culture, and well-defined career paths that reward and develop top performers.

More broadly, we recognize a need for retailers to fully adopt a digital culture. In such a culture, these high-performing merchants are encouraged and rewarded for taking risks and innovating. The next step is to go beyond the core working merchant team to leverage external networks and partnerships to drive performance further. All of these enablers come together through the use of key-performance- indicators-based steering to prioritize and track performance.

Starting the journey

Retailers of all sizes are looking to start the journey toward developing next-generation merchants. While several have made headlines for innovation in the space, many are simply trying to figure out where to get started. The most important thing for all retailers to realize is there is not a “one size fits all” approach to managing this transformation. We typically see functions and decisions addressed through a wide range of solutions and approaches (Exhibit 5).

Not every solution will perfectly fit these approaches. As such, we encourage retailers to think through the following key questions when determining their paths:

- What is the scale of the impact at stake? Determine if the returns of the decision offset the costs.
- What technology resources are internally available? Be realistic about the ability to implement that path forward.

Exbiti 5

Retailers typically use a range of approaches to address digitalrequirements and challenges related to their specific situations

	Ad hoc solutions	Third-party modules	Enterprise transformations
What it means	Bite-size approach is used to develop advanced analytics solutions Tools can be one-offs or “scrappy” in nature but target streamlining	Third-party solutions are leveraged to address specific business needs (eg, replenishment, negotiation, pricing) Tools are implemented based on business priority, and vendors are picked based on solution	End-to-end transformation of IT capabilities through homegrown, enterprise-level product solutions is used to cater to merchandising needs Integrated suite of tools (eg, leveraged platform capabilities, shared data sets) are implemented
When it makes sense	Returns on solutions are probably small, making heavy investment unrealistic Development resources are readily available to work on ad hoc requests Required data are readily available to end users	Use of tools makes financial sense (ie, returns are higher than costs) Ability to leverage external data is paramount and provided by third parties Enterprise-level development capabilities are not available	Scale of need matches scale of undertaking Appetite and energy to elevate technology’s role within organization and adopt a product-centric mind-set exist

— What is the problem you are trying to solve? Be honest with what you need and the scale of the solution needed.

— What is the timeline for success? Strike a balance between what is realistic and taking an agile approach to be flexible.

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Next-generation merchants will continue to sit at the heart of retailers and will be able to lead their organizations through incredibly dynamic times. They will spend more time on strategic issues, including category strategy, calendar development, and vendor negotiations, and steer away from backward-looking strategy reviews. This, in turn, will create greater process efficiency, and the results—for example, lower overhead—will make for leaner, more streamlined merchant organizations that can do more with less. Some manual routines might also be automated across systems, with the use of machine learning to highlight areas where merchants need to focus. Smart workf lows with integrated decision options will eliminate the need to jump among systems before taking action, and the insights generated will be available in real time and even when merchants are "on the go," which will reduce time behind the desk. These factors, in all, will define the next-generation merchandising landscape.

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Beyond procurement: Transforming indirect spending in retail

If retailers treat indirect costs as an opportunity for business transformation rather than just a procurement matter, they can boost return on sales by as much as 2 percent.

Steve Hoffman and Patrik Silén

For retailers seeking to cut costs and generate cash for growth investments, indirect spending can be a big untapped opportunity. Indirect costs—the goods and services that retailers purchase but don't resell—are equivalent to 10 to 15 percent of sales on average, and most retailers know that their indirect spending is far from optimized. But while recognizing the potential is easy, capturing it has proven stubbornly difficult.

The challenges aren't new. They include a lack of spending visibility, fragmented ownership and spend authority, a dearth of incentives to reduce indirect spend, and a siloed approach to procurement of not-for-resale (NFR) categories. In addition, indirect procurement typically focuses on negotiations with suppliers over price, rather than on higher-impact opportunities to optimize what and how the retailer buys. Our research has also shown that capabilities and resourcing for NFR procurement in retail are significantly weaker than in many other sectors: NFR goods and services are viewed as much less important than goods for resale, so the NFR sourcing staff tends to receive less management attention and less investment in talent. Furthermore, even NFR sourcing professionals typically have little expertise in NFR categories. Rare is the procurement team that has deep knowledge of, say, elevator maintenance or marketing-agency overhead costs.

Visionary retailers, however, are taking a radical new approach to indirect spending—and achieving radical results. These retailers aren't viewing indirect costs as a concern only for the procurement function. Instead, they're looking to transform indirect spending across the entire business. They're overcoming the challenges by leveraging three new ways of working: a cross-functional approach that incorporates category-specific demand levers, the use of digital and analytical tools, and stronger supplier collaboration. And they're taking specific actions to bring about lasting change in mind-sets and behaviors.

In doing so, retailers are shaving as much as 10 to 15 percent off their annual indirect spend, capturing impact worth 1 to 2 percent in return on sales, and seeing a more than fifteen-fold return on the cost of their NFR sourcing team. We've found that the value at stake is remarkably consistent across retailers— even at those that have been working on reducing indirect costs for a long time, whether in-house or with external support.

A business transformation

To capture maximum value from a cost-reduction program, retailers must be deliberate about the program's scope and ambition level. A broad scope and high targets are indispensable elements of a truly transformative effort.

Historically, retailers have cut costs primarily by reducing store labor or travel expenses. Few retailers have tapped into the full potential of optimizing NFR spending (Exhibit 1). Furthermore, even retailers explicitly seeking to reduce indirect spending sometimes ring-fence certain cost categories as "not addressable." For instance, some retailers consider marketing expenditures out of scope; their rationale is that marketing is critical to the core business of retail. Other retailers don't bother trying to lower rents, because they assume that they can't renegotiate terms unless they're in financial distress. Some indirect costs—such as supplier-managed logistics—remain unchallenged because they're "hidden" in cost of goods sold. And some retailers look for cost-reduction opportunities only in operating expenses, leaving all capital expenditures untouched—even though the latter often has higher savings potential (as a percentage of costs).

In bypassing these categories, retailers are forfeiting more than half of the potential impact and missing out on the synergies that a large-scale program could bring. To achieve transformative change in indirect spending, there can be no sacred cows.

Another must-do for a transformation program: set stretch targets that inspire creativity and out-of- the-box thinking. To set its NFR targets, one retailer first conducted a fact-based diagnostic that was championed by senior leaders. This exercise helped the organization understand that the program was a priority, adopt a transformational rather than an incremental mind-set, and focus on how to achieve the targets rather than on trying to change them.

New ways of working

Seeing an NFR effort as a business transformation is a crucial first step. To maximize NFR savings, retailers then need to adopt three new ways of working.

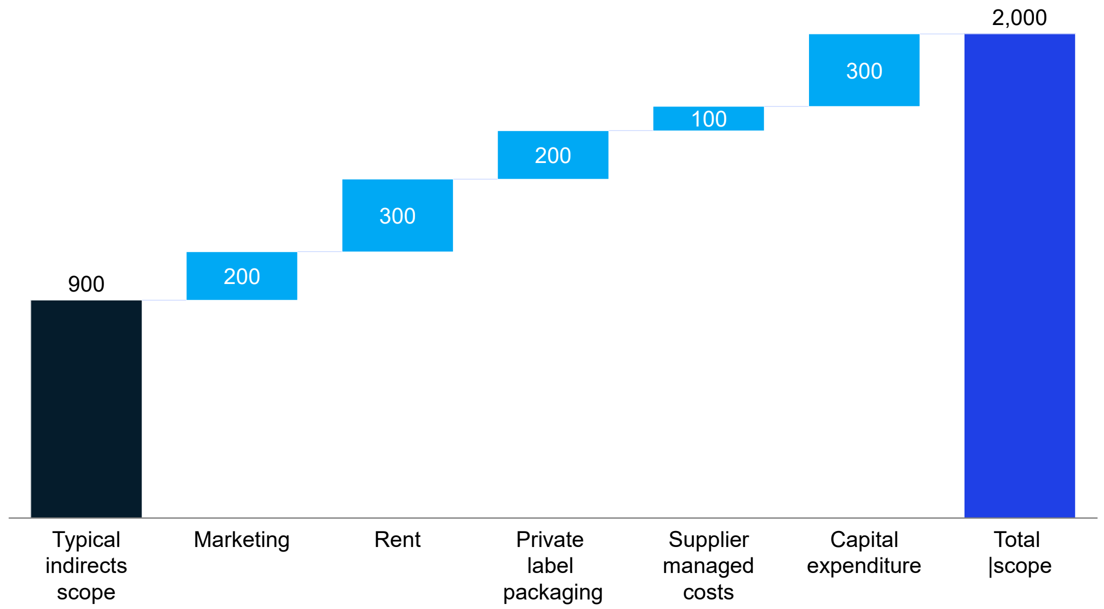
A cross-functional approach incorporating category-specific demand levers
Transformation of indirect spend will require the involvement and commitment of more than just the procurement staff. A cross-functional team can break down silos, pose tough questions about what the business really needs, and make balanced trade-offs.

A cross-functional team can pull the basic supplier- management levers (such as competitive bids and supplier consolidation) that affect who the retailer buys from and at what price. The team can also pull process-management levers, which inf luence how a retailer buys: if the various functions comply with procurement policies and use only preferred vendors, maverick spending will be reduced or even eliminated. Savings across the organization can be more easily tracked. The retailer can better negotiate vendor payment terms and cycles to its benefit.

Exbiti 1

By addressing the full cost base, a retailer can double the scope and savings of its indirect-costs program

Typical breakdown for a €10 bn retailer, € million



Typical savings, %	10-15	8-17	0-5	12-24	10-15	10-20	10-15

SOURCE: McKinsey analysis

Most importantly, a cross-functional team will be better placed to pull category-specific demand-management levers, which inf luence what the retailer buys. In our experience, these levers deliver as much as half of the potential savings—or even more for mature companies, because negotiating for lower prices yields diminishing returns over time. The biggest opportunities are often in areas that many retailers consider out of scope, such as marketing (by using a return-on-investment approach, for instance) or logistics (using levers such as inventory reduction or network redesign).

A retailer, seeking to optimize logistics spending, tasked a cross-functional team with redesigning its distribution network. The team was able to reduce end-to-end costs by selectively increasing certain logistics costs. For example, it switched some deliveries from sea to air in order to gain sales and reduce markdowns. It also increased delivery frequency for some products and stores while decreasing it for others.

The use of digital and analytical tools

Digitization has revolutionized every business process and will continue to do so; indirect sourcing is no exception.[1] Today, leading retailers are using digital and analytical tools in the following areas to achieve dramatic reductions in indirect costs:

— **Spend visibility.** Advanced digital solutions, powered by artificial intelligence (AI) and machine learning, enable retailers to rapidly and accurately map the relevant spend base into granular categories, shedding light on exactly who spends how much on what. Cutting-edge digital procurement solutions can pull purchase-order (PO) and invoice data from multiple systems to create a “spend cube,” automatically generating benchmarks on pricing and specs, as well as dashboards and reports to help category managers monitor spending. One retailer had recently streamlined its headquarters organization but found through AI-supported spend mapping that many of the costs had crept back in through the use of contractors and temporary labor. Once the retailer generated the spend cube using an agreed taxonomy, it could lock down a baseline and see how much it was spending on contracted versus uncontracted vendors.

— **Consumer insights.** A retailer used digital consumer surveys and crowdsourced competitor benchmarks to understand, address, and retest consumer perceptions of store cleanliness. Which areas of the store did consumers notice most? Which areas did they hardly notice at all? Analysis showed that the parking lot and the sidewalks were perceived as clean enough, so instead of hiring a cleaner to do a thorough cleaning multiple times a day, the retailer cut back to once a day, with store associates doing spot checks every few hours. The surveys also revealed places—such as fitting rooms and the shoe department—where the retailer could invest in more frequent cleaning to boost customer satisfaction. The business-insights team then measured the exact impact of these adjustments on the retailer’s sales.

— **Design to value.** A retailer reduced the cost of its paper shopping bags by 25 percent by redesigning them. Through digital analysis of basket size, product dimensions, and data from cashier surveys, the retailer determined the ideal dimensions of a shopping bag based on the distribution of physical volume and weight of products. Further digital analysis—along with input from cashiers, baggers, and vendors—helped the retailer arrive at the substrate composition that would give the shopping bags the right levels of puncture strength and tensile strength.

— **Clean sheeting.** Digital clean-sheeting tools can reduce indirect costs by as much as 40 percent in a category. Such tools typically feature algorithms for determining costs in various NFR areas, dynamic databases of input costs (such as raw-material index prices), and a sophisticated calculation engine. Through a clean-sheeting exercise, one retailer discovered that it was paying much more than the “should cost” for water-bottle labels (Exhibit 2).

— **Spend control.** Digital procure-to-pay tools give retailers better spend control by enforcing more discipline in how suppliers are set up and approved, and by supporting a more rigorous PO-approval process.

— **Zero-based budgeting (ZBB).** Using digital tools (and enabled by increased spend visibility), retailers can easily build detailed bottom-up budgets, detect the exact drivers of variances, and take swift action to close gaps. ZBB, which first gained traction in consumer-goods companies, can be powerful for retailers, especially in store-related NFR categories. Determining the appropriate budget for each store, and then tracking adherence to that budget, can yield significant savings.

1 For more on digital solutions in procurement, see Pierre de la Boulaye, Pieter Riedstra, and Peter Spiller, “Driving superior value through digital procurement,” April 2017, McKinsey.com.

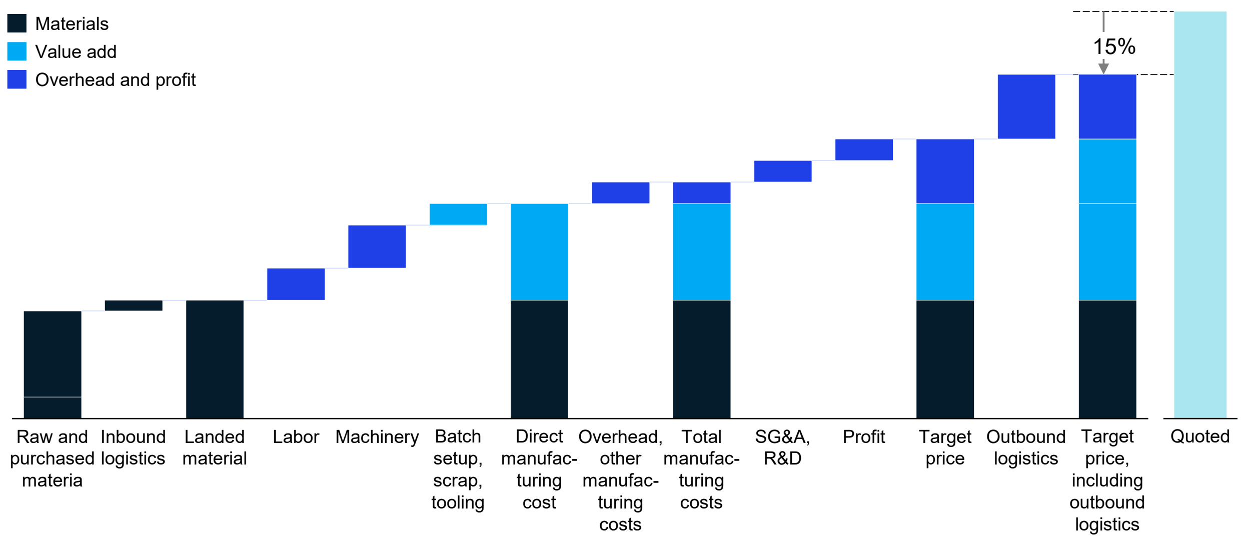
Exbiti 2

Through clean sheeting, a retailer saw that it was paying more than the 'should cost' for labels on its water bottles

Key assumptions

- Profit of 5% included in price
- Batch size of 2 million pieces (est.)
- Yearly volume of 6 million pieces (est.)
- Manufacturing location: Eastern Europe
- Interest rate of 3%
- Selling, general, and administrative (SG&A) costs of 5%
- Range of labor rates in local currency depending on skill level
- Selling tax and value-added tax not included

Label costs for 500ml bottle



SOURCE: McKinsey analysis

Closer collaboration with suppliers

Retailers should work with suppliers on cost improvements and innovations. Suppliers can be great idea generators because they know a retailer’s bad habits better than the retailer itself does and would rather help change those habits than lose the business. Retailers can also invest in improving supplier capabilities in ways that will pay the investment back several times over. Among the benefits of stronger supplier relationships: better product quality and availability, faster responses to market needs, less administrative effort, greater efficiency, and lower total cost.

The elements of successful supplier collaboration include focusing on a limited number of suppliers to deliver the highest return on investment, establishing a robust value-sharing agreement at the outset, creating a dedicated supplier-collaboration team separate from but aligned with category managers, and building a disciplined performance- management and benefits-tracking system.

One retailer, when retendering its contracts for outsourced warehousing, required suppliers to submit proposals for improving the joint warehousing operation. Based partly on these proposals, the retailer reduced its supplier count to two, allowing for closer collaboration while maintaining some competitive tension. The retailer built continuous- improvement targets into the contracts, with gainsharing incentives for the suppliers. It also invested in a “lean warehousing” team that works closely with the suppliers to build capabilities.

Getting it done

Retailers must embed these new ways of working into daily tasks. To sustain behavioral change, they must then use all four parts of the "inf luence model"[2] (Exhibit 3).

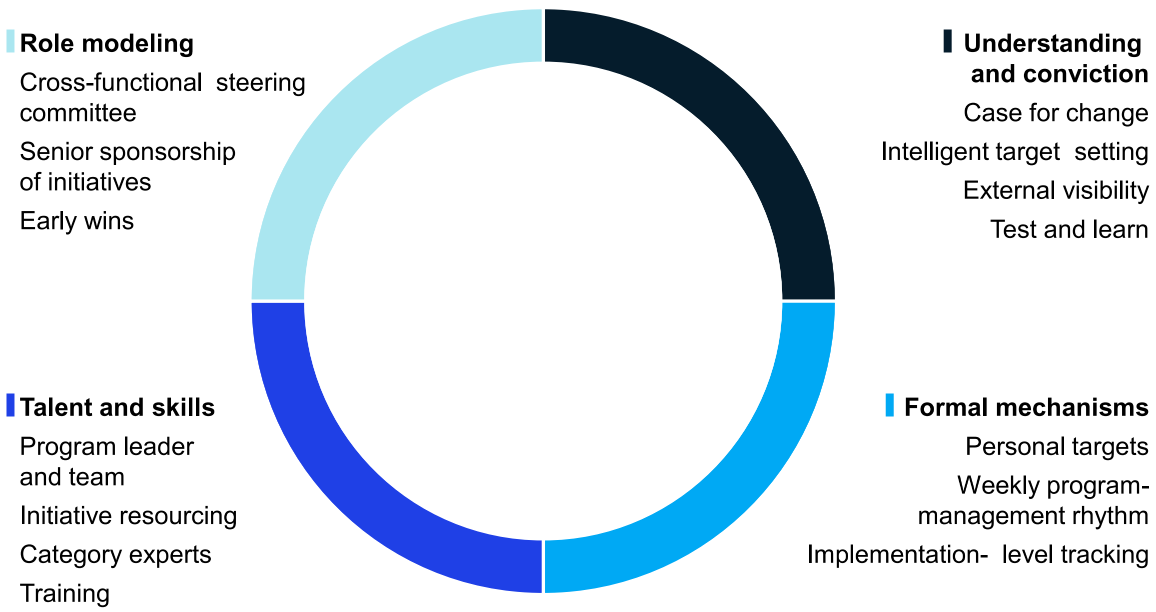
Fostering understanding and conviction
Leading retailers lay out a clear case for change and help each stakeholder connect to it on a personal level. An important aspect of the change story is communicating why savings are needed and what they will be used for. Allowing business units or functions to reinvest part of the savings can increase motivation. (One initiative leader at a retailer put it this way: "Half goes to the CFO, but the other half we get to keep.") The head office should, of course, have enough visibility into the reinvestments to ensure they align with corporate priorities and generate strong returns.

Intelligent target setting also helps foster understanding across the organization. Targets should be based on detailed diagnostics, including benchmarking against a relevant peer set. Otherwise, stakeholders will reject the targets as arbitrary; there's also a risk of damaging the business by pushing it into "slash and burn" cost cutting. The diagnostics should yield not just a single target— say, $100 million in cost savings—but also a set of quantified initiatives. Targets should include cost ratios (for example, logistics spending as a percent of sales) rather than just absolute numbers, to ensure that cost efficiency genuinely improves even when the category experiences tailwinds. (For example, a decline in logistics costs due to a decline in sales isn't really an improvement.)

Exhiti 3

Retailers can use a range of tactics to change mind-sets and behaviors

The influence model's four building blocks of change



[2] For more on the influence model, see Tessa Basford and Bill Schaninger, "The four building blocks of change," McKinsey Quarterly, April 2016, McKinsey.com.

Because indirect sourcing is typically perceived as a backwater and procurement staff can feel they're performing thankless work, external visibility can be highly motivating. When retail CEOs publicize their NFR initiatives and targets, the people involved in the initiatives see that their work matters and even has the power to influence their company's stock price.

Along the NFR journey, there will be times when stakeholders resist change for fear of negatively affecting sales. A test-and-learn culture can overcome this. A first step can be to show mock- ups or samples of proposed changes. One retailer's procurement team recommended using thinner, cheaper paper for marketing materials. It overcame resistance from the marketing department by having samples printed on the thinner paper and using blind testing to demonstrate that the materials were just as effective.

Reinforcing with formal mechanisms
Company goals should be translated into personal targets. One retailer created a simple time line of when initiatives were expected to deliver impact, using the top end of the impact range estimated for each initiative. The resulting quarterly figures became targets for the relevant executives, whose bonuses were partly dependent on hitting those targets.

To follow up on progress against targets, many retailers instinctively go for a monthly cadence of follow-up meetings. But, in our experience, a weekly program-management rhythm is much more effective for driving the pace of initiatives and bringing about cultural change. During the weekly meeting, the team reviews all initiatives but focuses on only a few, either on a rotating basis or to help those that need additional support.

Initiatives should be tracked not only against milestones but also on progression through "implementation levels": an initiative begins as an idea, matures to a business case, becomes an approved decision, gets implemented, and is ultimately converted to "money in the bank." The expected impact of initiatives can be appropriately "discounted" when they are in earlier stages. Implementation-level tracking gives the program leader and steering committee a more accurate picture of when impact will be delivered and which initiatives need what kind of support. Linking this tracking to ongoing budgeting, forecasting, and performance-management processes yields greater transparency in profit-and-loss performance.

Developing talent and skills
An NFR program needs a capable program leader and a supporting team. The program leader, who will likely come from a line role, should know the business well and have the respect of top management. Given this individual's talent and leadership skills, it won't be an easy decision for senior executives to free him or her up to lead the program. But the sacrifice will pay off.

Still, without sufficient resources for each initiative, the program will struggle. Colleagues from each function or cost category will need to dedicate 10 to 20 percent of their time to the effort. For one $10 billion retailer, delivering $200 million in savings required a program leader and about 40 full-time equivalents (FTEs) working for 12 months. Company leadership had to stop or pause other initiatives to create the required capacity. While 40 FTEs might sound like an enormous investment, the retailer recouped the cost of those employees' yearlong efforts about 50 times over in recurring savings.

Neither the program leader nor the team members can be expected to have all the relevant category-specific expertise. Our research shows that retailers have eight times the indirect spend per procurement professional compared to other sectors, which means their level of expertise in any particular category will be relatively shallow. Therefore, tapping into internal and external category experts is crucial. One grocery retailer discovered that one of its project managers had been a refrigeration engineer for 25 years. The company brought him into a team tasked with reducing the life-cycle cost of refrigeration, heating, and cooling assets by 30 percent in two years. The team achieved the goal in six months and did so with simple solutions—for example, changing the type of price tags used in refrigerated shelves so that the tags wouldn't fall off and clog the drain. This change saved the retailer more than $600,000 a year.

Capability building is also key. The best companies use a combination of classroom training, e-learning tools, and on-the-job coaching. In our experience, many NFR professionals who receive functional and category-specific training and mentoring immediately double or triple their effectiveness. A phased train-the-trainer approach—in which the sourcing team receives training during a pilot phase, applies the learnings to an initial set of categories, then trains others in the next phase—has proven effective in many cases.

Role modeling

The CEO, CFO, and the rest of the management team must work together to communicate the case for change and role model the desired mind-sets and behaviors. Working as a cross-functional steering committee, they can remove roadblocks, surface and capture cross-functional opportunities, and allocate enough resources to them, thereby sending an unmistakable message to the organization about the importance of these initiatives.

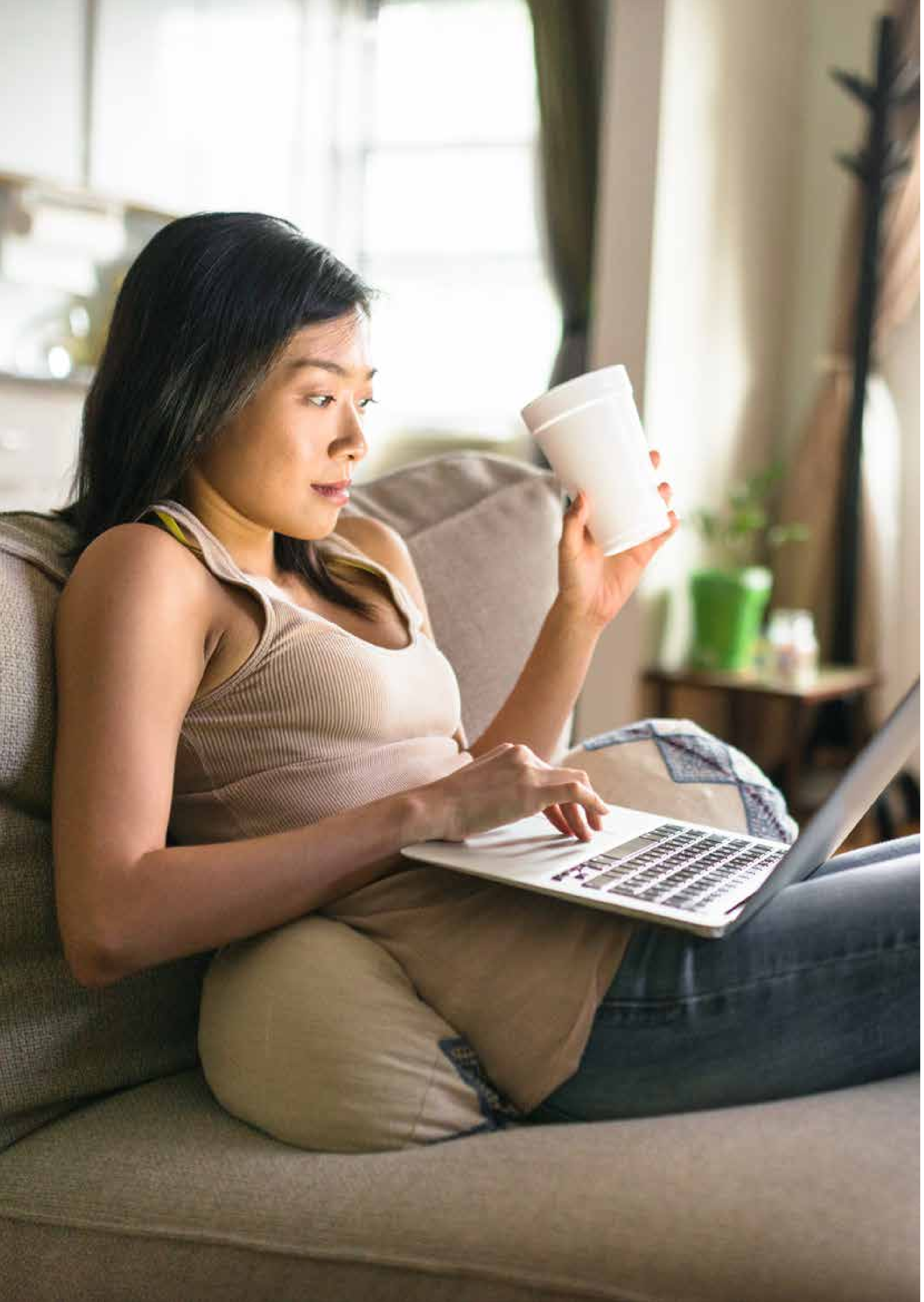
Another powerful role-modeling lever is senior sponsorship of initiatives. Senior leaders can serve as coaches for the owners of individual category initiatives, whether those owners are within or outside the senior leaders' respective functions.

Helping to secure—and then celebrate—early wins is also a form of role modeling. It lets the entire organization see that senior leaders are committed to ensuring the NFR program's success and that they recognize its impact.

■ ■ ■

Most retailers have significant opportunities to reduce indirect costs. The first step is to acknowledge that the potential exists, then conduct a thorough diagnostic to quantify it. Though challenging, a transformation in indirect spending can yield greater profitability, funding for growth, and competitive advantage.

Steve Hoffman is a partner in McKinsey's Chicago office, and **Patrik Silén** is a partner in the London office.



What Chinese consumers want from fresh-food retailers

We surveyed nearly 5,000 consumers in China to discover how they buy fresh fruits, vegetables, and meats. Here's what we learned.

Younghoon Kang, Dymfke Kuijpers, and Alex Sawaya

Around the world, leading grocery retailers are differentiating themselves and attracting shoppers to their stores by investing in their fresh-food departments. Fresh food, after all, has a high basket penetration and is a big driver of custom-er loyalty. It also has a strong halo effect: if shoppers are satisfied with a retail-er's fresh offerings, their perception of the retailer's other departments im-proves as well, resulting in more customer traffic and higher overall sales for the retailer. And fresh winners have outperformed the competition in profitability.[1]

In China, however, most hypermarket and supermarket chains haven't gained much ground in the battle for the fresh-food shopper. Most Chinese consumers still prefer to buy fresh food from wet markets, where they can haggle over pric-es—a beloved cultural practice that isn't part of the shopping experience at mod-ern grocery stores. Furthermore, Chinese shoppers perceive the products sold in wet markets as being truly fresh, straight from the farm or field. Wet markets' share of wallet in fresh food was more than 50 percent in 2017, according to our analysis of Euromonitor data.

Do China's hypermarkets and supermarkets stand a chance against wet markets? We certainly believe so. Our survey of more than 4,900 urban Chinese consum-ers in 29 cities across the country (see sidebar, "About our research") reveals opportunities for modern retailers to compete more effectively in China's fresh-food retailing market. Specifically, we found that if modern retailers take a customer-centric approach to product quality, emphasize their unique features, and seamlessly integrate their physical stores with digital capabilities, they'll be well positioned to win in fresh food.

Key Buying Factors In Fresh Food

In our 2018 survey of fresh-food shoppers in China, 85 percent of respondents said they buy all their fresh food offline. An even higher percentage—88 per-cent—said they'd shopped at a wet market at least once during the previous three weeks. Only 19 percent said they'd shopped at a supermarket over the same pe-riod, and a mere 16 percent had visited a hypermarket in that time frame.

1 Based on our analysis of the economic profit of 38 leading food retailers around the world from 2011 to 2016.

Our survey also revealed that none of the large retailers in China stand out in consumers' minds as a fresh-food winner. (When we conducted similar surveys in four European countries and the United States, consumers recognized at least one modern retailer in each country as being exemplary in fresh food. That wasn't the case in China, which means there's vast opportunity in that market for a focused, innovative retailer to rise above the competition.)

For China's offline shoppers, product quality is the biggest factor in their deci-sions about where to shop for fresh food. Quality is also the primary factor that determines whether they'd recommend a retailer's fresh-food department to other people. But not all fresh products are equal in consumers' eyes: our survey brought to light the items that disproportionately influence Chinese consumers' quality perception. We call these products key quality items (KQIs). If a retailer improves the quality of just these few items in its stores, it will boost customer satisfaction significantly.

Countrywide, in vegetables the KQIs are leafy greens and tomatoes; in fruits the KQIs are oranges, apples, and bananas; and in meats, it's poultry and pork (Exhibit 1).

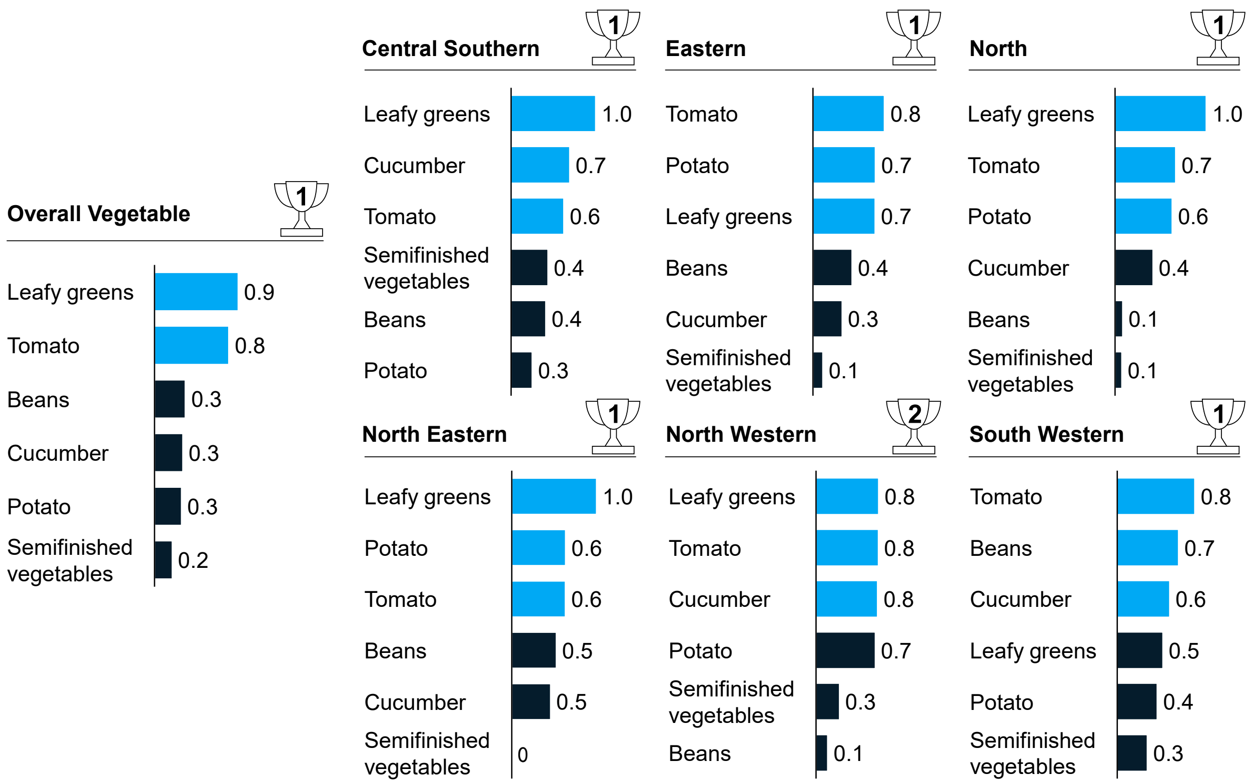
Quality is not only the most important buying factor for most of the country's fresh-food shoppers; it's also the biggest opportunity for China's retailers. Our survey shows that only about half of retailers satisfy Chinese consumers when it comes to quality, whereas 69 percent of retailers already meet the bar in as-sortment and 60 percent in convenience.

That said, a growing percentage of consumers are becoming omnichannel fresh-food shoppers, lured by the broader assortments of online retailers and the convenience of buying online. Assortment and convenience take precedence over quality for these omnichannel shoppers, who tend to be relatively young (in their early thirties or younger) and live in higher-income households in tier-one cities.

Exbiti 1

Leafy greens and tomato are key quality items in Vegetable, but regional differences exist

Importance of quality for retailer (importance for customers & customer penetration)[1]



1 Combined score of correlation of perceived product quality with the perceived department quality, adjusted for share of customers buying the product

SOURCE: McKinsey China Fresh Market Survey (2018, N=4993)

Indeed, the primary buying factors for fresh food appear to vary by life stage. The youngest consumers are most interested in convenience, while consumers 25-34 years of age are the most price-sensitive (Exhibit 2).

How To Win In Fresh-Food Retail

What are the implications of these survey findings for hypermarkets and su-permarkets? In our view, modern food retailers in China should focus on three must-dos:

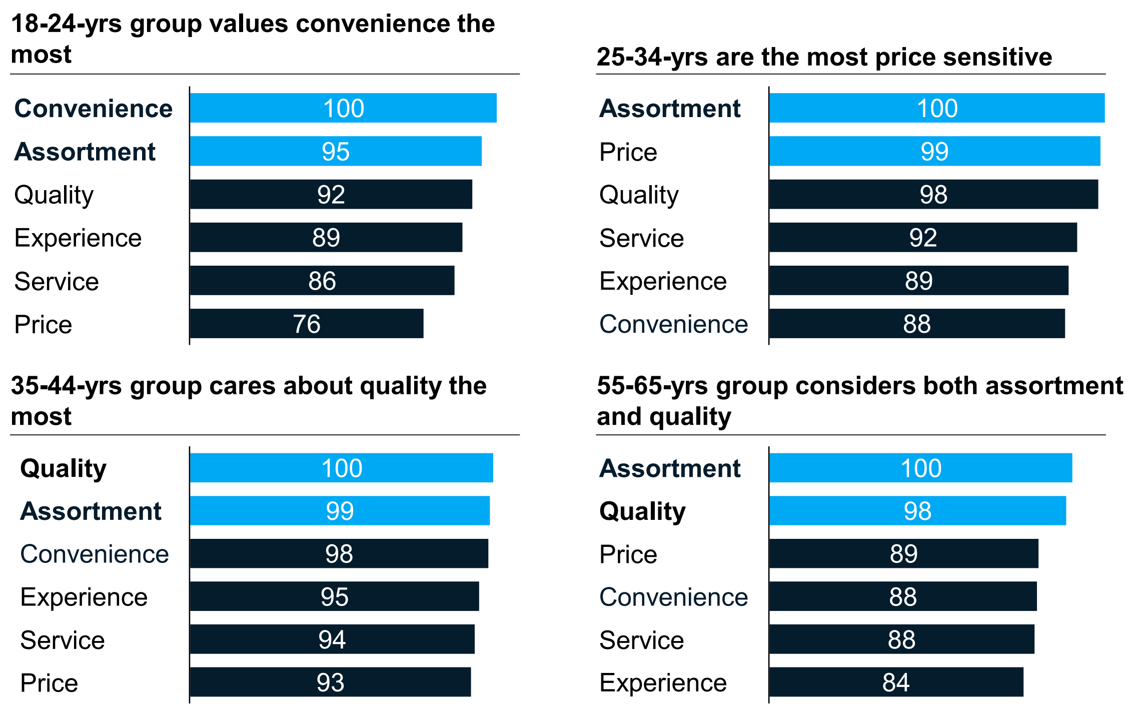
Identify KQIs and improve the quality of each one

A retailer should identify the KQIs in its fresh-food categories—keeping in mind that regional differences in consumption habits make for region-specific KQIs—and then focus its quality-improvement efforts on those products. It should determine not just which items are KQIs, but which specific attributes are important to customers and how the retailer compares to its competitors on those attributes.

Exbiti 2

Consumers are taking a more nuanced view of brands

Indexed importance for NPS of the whole store



SOURCE: McKinsey China Fresh Market Survey (2018, N=4993)

In an October 2016 article, our colleagues describe a proven methodology for identifying KQIs and improving the quality of each one.[2] The approach consists of three main phases:

— Conduct structured consumer research. Through in-depth dynamic sur-veys, understand which products and attributes truly matter to your cus-tomers. Benchmark your performance against competitors.

— Pinpoint the root causes of poor quality. Hold intensive workshops dedi-cated to root-cause analysis. Collaborate with suppliers to develop con-crete action plans to address the root causes. Identify quali-ty-improvement levers across the value chain, including in sourcing, forecasting, and in-store operations.

— Foster a quality-focused organizational culture. Embed the KQI ap-proach into commercial processes to instill a mind-set of continuous im-provement. Incorporate quality metrics into your perfor-mance-management systems.

For food retailers in China that choose to follow this methodology, the payoff will be well worth the investment. When a Chinese supermarket chain imple-mented this approach, it found that oranges were among its KQIs. It also dis-covered that its customers pay the most attention to the following attributes when buying oranges: "stays fresh long after purchase," "great texture and con-sistency," "smells nice," and "good condition at time of purchase" (e.g., no rot or bruises). Shoppers gave the retailer's oranges high scores against competitors in the first three attributes, but poor scores on the fourth.

The retailer therefore introduced a targeted set of actions to ensure that its or-anges wouldn't rot or get damaged during transport and handling. For example, it redefined its product specifications, stopped placing end-of-season orders (when the fruit tended to be overripe), and tightened its inspection guidelines. Within a year, the retailer saw a 7 percent increase in its fruit revenues.

Play up your strengths

Wet markets are no match for hypermarkets and supermarkets when it comes to certain aspects of assortment and experience (Exhibit 3). For one, modern gro-cers carry a much larger assortment that includes imported goods and organic products, which are increasingly in demand as more Chinese consumers are looking to "trade up" and are willing to pay a premium for such products. Also, modern grocers are a one-stop shopping destination whereas wet markets sell only fresh foods. Another differentiator is the shopping experience that modern grocers offer: a clean indoor environment that allows customers to browse neat-ly stacked shelves and receive after-sales services (such as discount coupons or home delivery).

Hypermarkets and supermarkets should emphasize these features in their mar-keting and customer communications. They might, for example, highlight im-ported or organic products in their ads—and perhaps even tell interesting stories about the products' origins and sources.

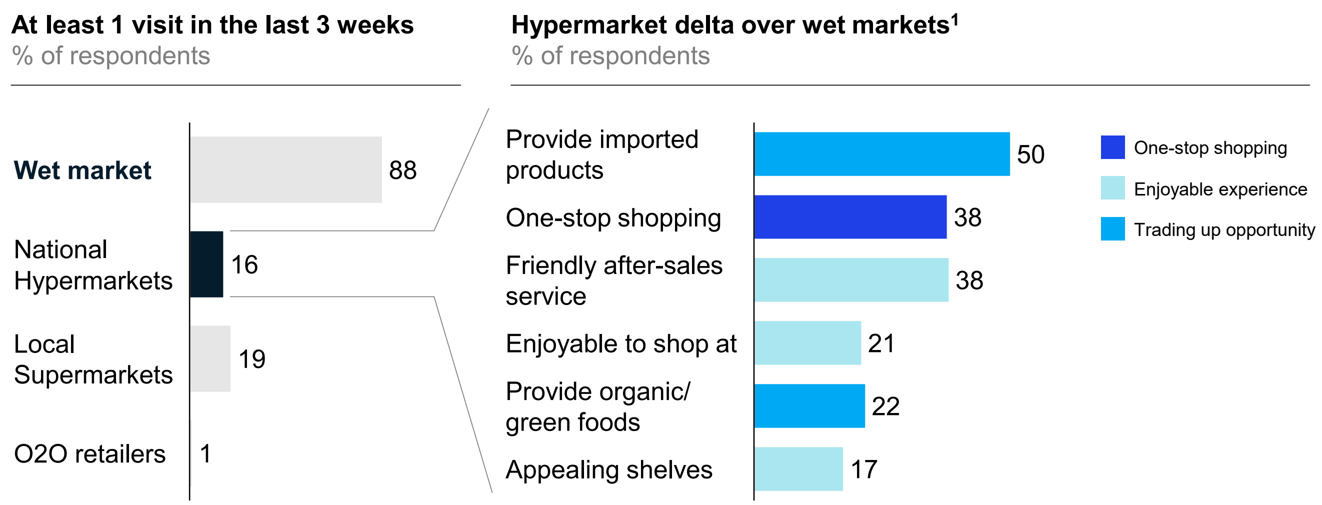
Modern retailers can further enhance the shopping experience through "re-tail-tainment." They could seek to become not just shopping destinations but leisure and entertainment destinations for the entire family. This is particularly relevant as Chinese culture becomes even more family-oriented. In a 2016 McKinsey Insights China consumer survey, 64 percent of respondents—up from 40 percent in 2011—agreed that "going shopping with family is one of the best ways to spend time with them."

To that end, a number of supermarkets in China—including 7FRESH, Hema Fresh, and Super Species—now have restaurants on site. Shoppers can pick out fresh ingredients, have them cooked, and eat a full meal with their family, all without leaving the store. At some Hema restaurants, robots deliver the food to diners, making for a novel dining experience. At Super Species, customers can play a supermarket version of a classic arcade game: they use a re-mote-controlled mechanical claw to try to pick up live crayfish.

[2] Raphael Buck, Daniel Läubli, and Nora Ottink, "The quest for quality in fresh-food retailing," Perspectives on retail and consumer goods, October 2016, McKinsey.com.

Exbiti 3

Hypermarkets can win wet markets by offering on an enjoyable end-to-end shopping experience and the opportunity to trade up



Hypermarkets can attempt to gain share from wet markets by differentiating in 3 key areas:

- **One-stop shopping destination:** consumers purchase beyond fresh foods and fulfill all the shopping needs in a single location
- **Enjoyable experience:** a clean and pleasant environment throughout the process of browsing items to after-sales
- **Trade up opportunity:** Chinese consumers increasingly demand and purchase premium imported products and organic products

1 Top-rated hypermarket attributes split by sub-category

SOURCE: McKinsey China Fresh Market Survey (2018, N=4993)

Develop a distinctive online-to-offline offering

A few retail chains have recently made considerable headway in luring consum-ers to its fresh-food offerings. For example, Hema—owned by Alibaba—entered the market just two years ago but is poised to gain between 15 and 30 percent of fresh-food market share over the next five years. Chinese consumers are drawn to Hema's "Daily Fresh" program, whereby fresh produce and meat are taken off store shelves at the end of the day, to be replaced with a new supply the follow-ing morning. Hema also has an attractive online-to-offline (O2O) value propo-sition: consumers can scan products with their mobile phones while in the store, order on the app, or shop on the website—and have their orders delivered with-in an hour, provided they live within 3 kilometers of a Hema store.

As more Chinese consumers gravitate toward omnichannel shopping, hyper-markets and supermarkets must develop a compelling O2O offering. Because China's e-commerce market is both the world's largest and the world's fast-est-growing, giving customers a seamless O2O experience is especially critical to retail success in China. Retailers need to either build or acquire the requisite capabilities—for example, through licensing or partnership.

RT-Mart's partnership with Alibaba, for instance, gives RT-Mart access to many of the features that have contributed to Hema's success: the Daily Fresh program, mobile and online ordering, and quick last-mile delivery. Alibaba also provides in-store digitization through upgrades to RT-Mart's point-of-sale and self-checkout systems. Furthermore, RT-Mart has added some of Alibaba's pre-mium brands to both its in-store and online assortments. The impact: RT-Mart is on track to increase both sales and profits, with online sales rising to 20 per-cent of total sales (up from 3 percent before the partnership).

Fresh-food retailing will only become more competitive. To stem further mar-ket-share losses, hypermarkets and supermarkets must find ways to deliver what the Chinese fresh-food consumer increasingly wants: high-quality products, broad assortments, and a convenient O2O experience. And, given the pace of change in China's retail landscape, there's no time to lose.

About our research

In March and April of 2018, we surveyed more than 4,900 fresh-food shoppers in 29 Chinese cities across the country: 6 cities in the Southwest and Northwest combined, 6 in the North and Northeast combined, 8 in the East, and 9 in Cen-tral South China. One-third of survey respondents were from China's four ti-er-one cities: Beijing, Guangzhou, Shanghai, and Shenzhen.

We asked shoppers a set of structured questions about their perceptions of the fresh-food offerings of various retailers, including four national grocery chains and three leading e-commerce players, as well as wet markets, traditional spe-cialty stores, and regional offline and online retailers. We also asked which fresh fruits, vegetables, and meats mattered most to them and which attributes of these products were most important. The survey gauged consumers' overall sat-isfaction with each retailer at the store level, their perceptions of the quality of each retailer's fresh-food department, and their quality judgments of 19 specific fresh-food items.

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The authors would like to thank Joanna Mak for her contributions to this arti-cle.

What Singles Day can tell us about how retail is changing in China

Singles Day is the largest single-day sales event globally, but new trends are changing what it means inside and outside of China.

Lambert Bu, Anne Kronschnabl, Kelly Ungerman, and Daniel Zipser

This year's Singles Day (China's shopping event on November 11, or "Double 11") clocked in as the biggest shopping spree the world has ever seen. Consumers purchased $45 billion (314 billion renminbi) worth of goods and services in a 24-hour period. To put it in perspective, this is three times this year's Black Friday and Cyber Monday online sales combined, and more than 90 percent of it happened on mobile devices, compared with 34 percent mobile purchases on Cyber Monday.

Started by the Chinese e-commerce giant Alibaba, which took a celebration for single people and began promoting it as a major shopping day ten years ago, this year's Singles Day featured at least four other retail platforms or ecosystems of companies, with Alibaba capturing 68 percent of total sales.

McKinsey took a hard look behind the eye-popping sales numbers to understand this year's business implications: where Singles Day is headed, who the winners were and why, and where the growth came from.[1]

Singles Day's growth is slowing and will need to further evolve

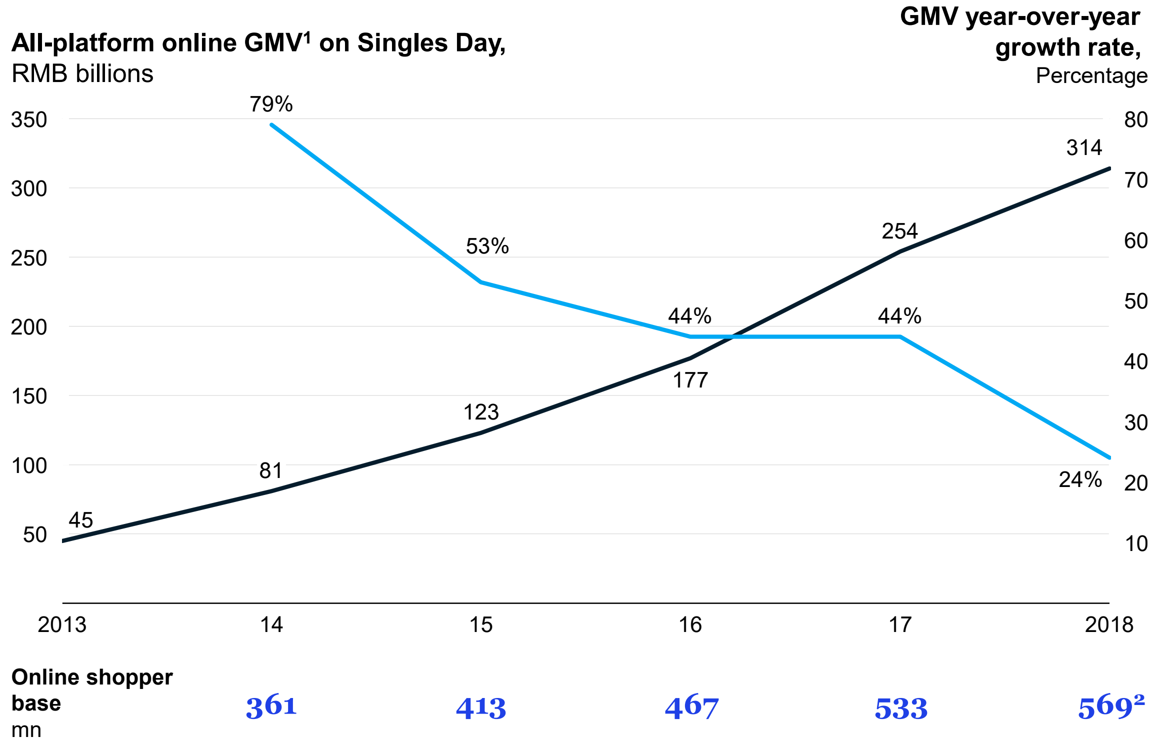
Over the past five years, Singles Day sales have been on a tear, leaping an average of almost 50 percent year over year and significantly outpacing the overall growth of online retail in China. This has made it relatively easy for brands to post large sales numbers on Singles Day.

But the rate of growth of Singles Day sales is declining (Exhibit 1). This year's 24 percent increase, as compared with 44 percent in each of the past two years, is more in line with the growth of online retail in China. What this suggests is that both retail platforms and brands will have to look at new avenues of growth for Singles Day. That could include more aggressively tapping new markets outside of China (more on this following) or more creatively leveraging complementary events. This year, for example, online games and interactive shows, including a "See Now, Buy Now" fashion show that let consumers buy items featured on models, helped stoke excitement leading up to Singles Day. The actual day kicked off with a four-hour, star-studded gala of performances in Shanghai's Mercedes-Benz Arena, watched by 240 million viewers.

[1] For this analysis, McKinsey relied upon multiple sources: Syntun and VennData reports, expert interviews, and press searches.

Exbiti 1

Singles Day absolute GMV growth and year-over-year growth rate[1]



1 Gross merchandise volume
2 As of June 2018

Source: Syntun, CNNIC

Whatever the approach, it is clear that brands and retailers will need to be more disciplined and realistic in setting forecasting goals, tapering their promotional spending accordingly and rationalizing their online sales across the whole year, including other holiday peaks as well as "super category days" and "super brand days."

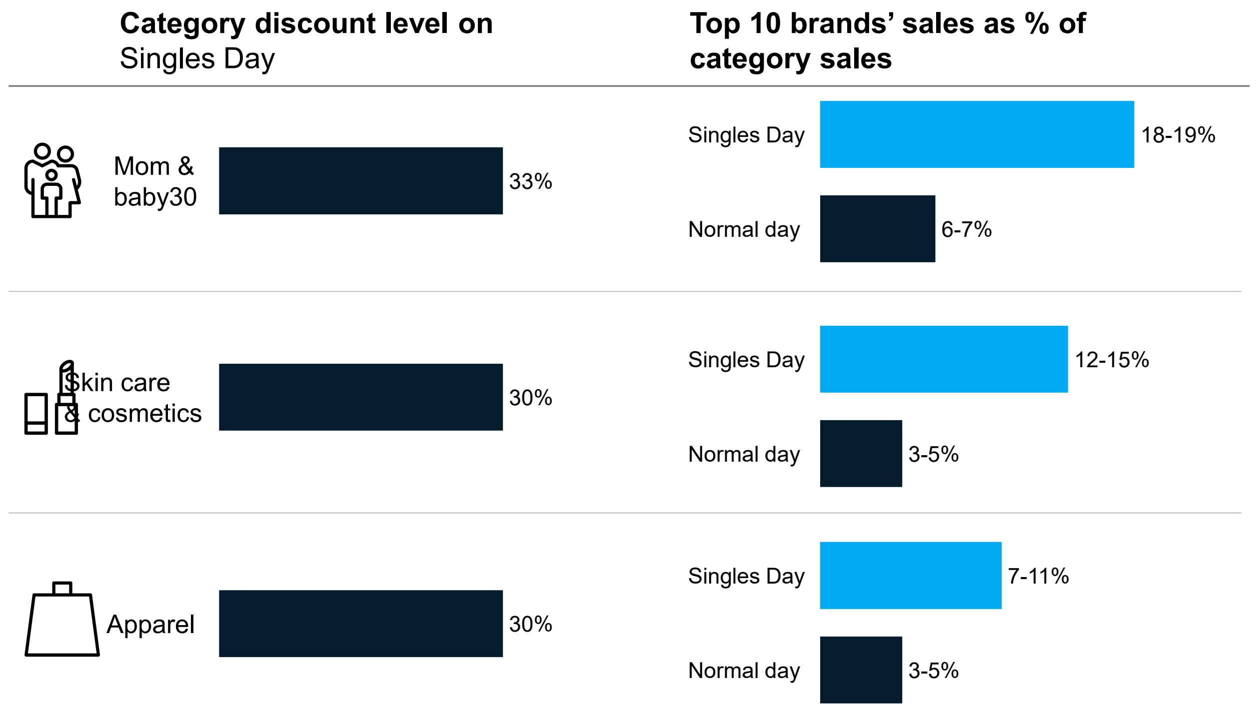
Discounts play a big role in Singles Day sales

On Singles Day, getting big sales lifts meant offering consumers big discounts on products. The categories with the biggest price cuts were not only among the best sellers, but they also succeeded in driving additional market share. Parent and baby products, with an average discount of 33 percent, captured 18 to 19 percent of category sales in China, versus 6 to 7 percent on a normal day. Skin-care and cosmetics brands, with an average price cut of 30 percent, boosted their share to 12 to 15 percent, up from the usual 3 to 5 percent (Exhibit 2).

Discounts took several forms: direct online price cuts, coupons that could be used both online and at brick-and-mortar stores, promotions offered during presale events, and platform discounts of-fered by Alibaba's main e-commerce site, Tmall. One interesting development this year was that Alibaba also offered discount coupons to incentivize shopping back and forth across its ecosystem. Users of at least 20 Alibaba subsidiaries (such as Ele.me, social media, music streaming, and travel apps) were able to participate in on-platform games to get coupons they could redeem on Tmall.

Exbiti 2

Brands can hardly escape from the discount battle, leaving very little room for small brands



Source: VENNData Double 11 report, aggregated expert interviews

Yet even though heavy price reductions are essential for Singles Day success, brands need to be careful to avoid participating in a race to the bottom. This is particularly true for smaller brands, which don't have the deep cash reserves to compete through discounts. One way to avoid unprofitable sales is to pair more modest discounts with free gifts or shift the emphasis toward product launches. This year, for example, Dyson used social media to promote its new Airwrap hair-curling product that was launched exclusively on Singles Day. In the first three minutes, the company sold 1,500 units on Tmall. Similarly, Budweiser created special-edition packaging of its beer and sold all of the 30,000 packs it produced, and Johnson & Johnson introduced new fruity and f loral f lavors of Listerine.

Singles Day is spilling over to physical stores

This year for Singles Day, e-commerce giant Alibaba made a concerted push to connect its online op-erations with its stores throughout China. Alibaba made sure consumers could find the Singles Day promotions and offers off line as well—in 62 Intime department stores, around 100 Hema supermarkets, and 222 Easyhome furniture and home-improvement stores.

Individual brands also used discounts and tactics such as click and collect to drive additional sales in stores. Luckin Coffee, a Chinese startup that's competing with Starbucks, featured a "Buy 1, get 2 free" discount that could be claimed online and used in any off line store. The promotion drove additional store traffic and fueled a total of 18 million cups (including coupons) sold in a seven-day period, which is equivalent to a 62 times bump in the number of cups sold per normal day. Similarly, consumer electronics brand Xiaomi grew its sales by 110 percent on Singles Day, from $353 million in 2017 to $754 million in 2018, by giving store shoppers the same discounts available online and by featuring smart home products that are best experienced in person.

While off line store purchases are still a relatively small percentage of Singles Day sales—less than 2 percent of Alibaba's sales came from its Hema and Intime stores[2]—omnichannel sales on Singles Day can have outsized importance. Retail platforms and brands should seek to drive omnichannel promotions because they give consumers the seamless integration of online and off line they desire. Omnichannel tactics also motivate people to visit stores where brands can create the kind of meaningful experiences and helpful interactions typically not found online.

Rooted in China, Singles Day is an increasingly global event

This year, a record number of multinational brands (more than 19,000) participated in Singles Day, which resulted in a major spike in sales from imports. While overall Singles Day sales grew by 24 percent, the growth of products imported into China was much higher, at 63 percent on Tmall.[3] Among the top-selling multinational brands on Tmall were Spanish beauty company MartiDerm, Japanese diaper brand Moony, Dyson appliances, and the US supplement brand Schiff. For international brands, this means that Singles Day can be an important opportunity to drive product sales growth in China. Alibaba's Tmall offers access to a large consumer base and has architected a wide range of supporting capabilities, such as data analytics, logistics, and product innovation, that allows companies to easily sell on its platforms.

At the same time, Singles Day fanned out across the globe, with multinational e-commerce sites offering big discounts and doing heavy promotion for the shopping event. Most of these sites saw major increases in their customer sales and orders on Singles Day. Lazada, which is approximately 91 percent owned by Alibaba,[4] featured Singles Day in Singapore, Malaysia, Thailand, Indonesia, the Philippines, and Vietnam, and saw its initial sales during the first hour of Singles Day grow sevenfold over last year. Shopee, the leading online shopping platform in Southeast Asia and Taiwan, grew its total customer orders on Singles Day by 4.5 times.

[2] Sales from brick-and-mortar stores were not actually counted in this year's Singles Day total.
[3] From Syntun
[4] As of March 31, 2018.

Farther afield, US apparel seller Shopbop offered discounts on Singles Day. Alibaba, which has said its long-term goal is to get half of its total sales from overseas, brought Singles Day to the United Kingdom, France, Spain, Poland, Russia, and Turkey through AliExpress, an online site that exports Chinese products to international buyers. In Europe, AliExpress partnered with El Corte Inglés department store to create more than 2,000 click-and-collect pickup locations, including pop-up stores. This year, AliExpress's total sales on Singles Day were up 40 percent.

As Alibaba and other Chinese retail platforms continue their expansion abroad, we can expect to see significant growth in Singles Day sales in Southeast Asia and other markets, potentially through partnering with companies like Lazada or Shopee.

Although Singles Day year-over-year growth is slowing, the event is still a behemoth for Chinese retail and represents a significant opportunity for brands to grow in China. Participating is no longer optional but a requirement for any international brand that sees itself with a future in Asia and wants to build brand engagement and craft unique experiences with consumers.

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