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How U.S. CPGs can get their groove back

Manufacturers must find ways to grow beyond the grocery channel

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Executive summary

Once the most straightforward of markets, the United States has become a frustrating puzzle for executives of consumer packaged goods (CPG) companies. Changes in consumer behavior, the emergence of smaller competitors, and the proliferation of retail formats — the grocery channel has lost share to club, dollar, and convenience stores — have created a much more complex environment. Adding to the challenge is the fact that U.S. population growth — a core element of CPG companies' past success in the country — is expected to remain low for at least the next decade.

Achieving sales growth in the increasingly complex U.S. market will require large CPG companies to make significant changes. Some previous practices — such as the investment of hundreds of millions of dollars in mainstream advertising or in trade promotions — have become outmoded and should be rethought. The new prerequisites for winning include the development of more effective product portfolios, the use of innovative merchandising, and the flexibility to work with different retail formats (including online distributors) whose volumes and SKU requirements may be unique. At a time when some retailers and consumers are starting to care about health and the environment, CPGs may also need to rethink institutional branding.

The changes mean that large CPG companies will need to develop new or enhanced capabilities, especially in their supply chains and innovation departments, and bring more rigor to their marketing and promotional activities.

A discombobulated CPG world

In the last 10 years, the success factors for consumer packaged goods (CPG) companies have undergone a radical shift. Consumer behavior, retail distribution, and the nature of competition have changed so fundamentally that if you had received a knock on the head and spent the last few years unconscious, you would barely recognize your surroundings. About the only thing you'd know is that you weren't in Kansas anymore.

The changes are proving particularly challenging for large CPG companies, and nowhere more so than in North America. Whereas the big food and packaged goods companies once led the way in the United States, now it is mostly smaller companies that are demonstrating above-average performance (*see Exhibit 1, next page*). Big CPG companies aren't getting anywhere near the growth they expect, certainly not through organic means.

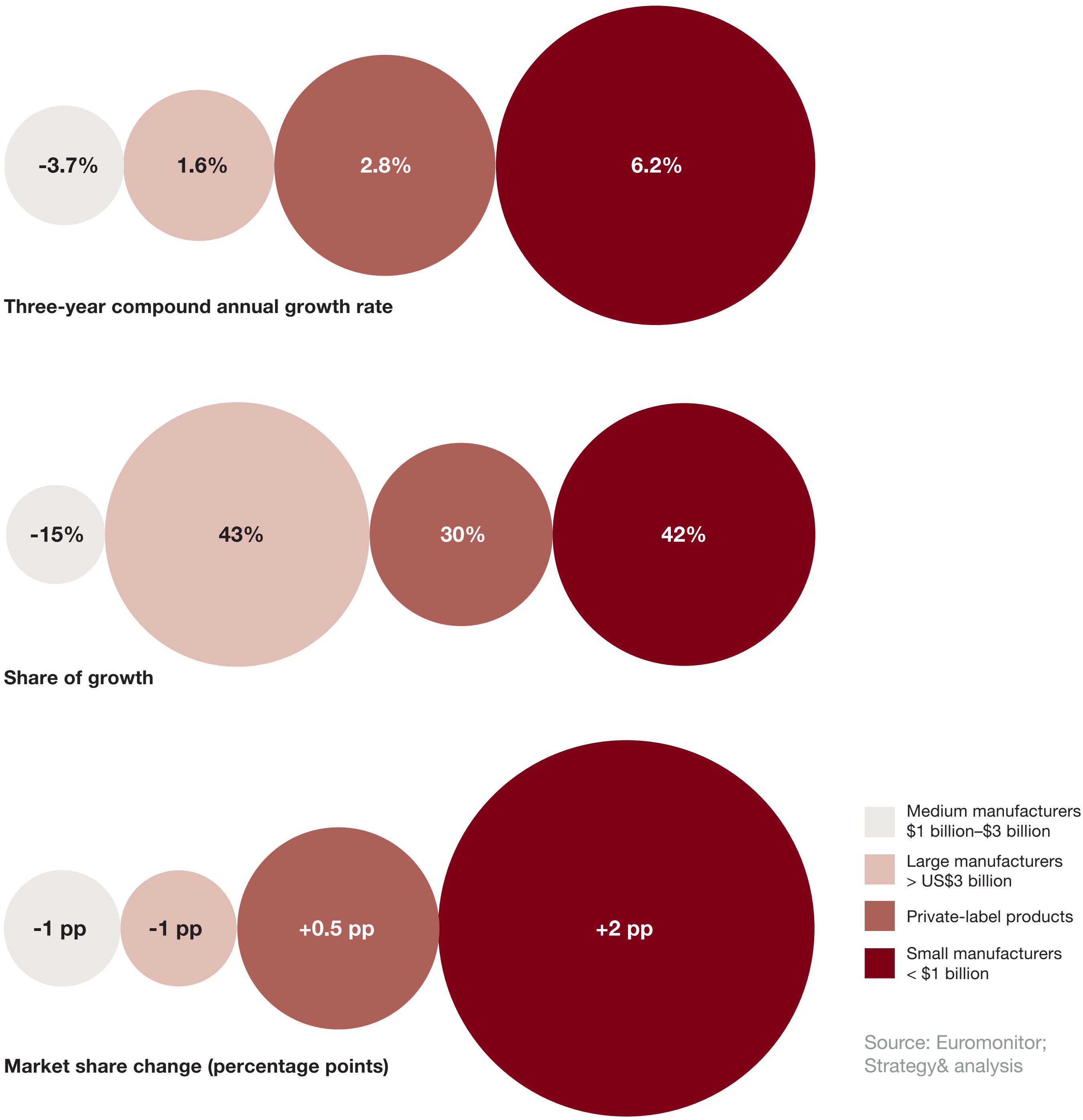
This has made the U.S. a priority for North American CPG executives, and it's no secret why. With revenue roughly equal to that of all of Latin America combined, and huge profit potential, the U.S. is the most important market in the Americas by far. Yet it is also one of the markets that has been reshaped most dramatically — by new consumer behaviors, by the fragmentation in retail, and by the rise of smaller food and beverage companies with a new set of value propositions, often rooted in healthier or more sustainable products.

We believe there are ways for large CPG manufacturers to find their way in this more complex environment, but no one answer will work for every company. Companies should start by understanding what has changed that affects them most directly, and use that new understanding to fine-tune their strategies and make sure they have the capabilities to support them.

The changes are proving particularly challenging for large companies in North America.

Exhibit 1
Growth is shifting from large manufacturers to private-label and small, focused players

Market growth and share performance for packaged foods in the U.S.
(By manufacturer size, 2009–12)



Source: Euromonitor; Strategy& analysis

What CPGs now face

To be sure, there have been periods in the last few decades when U.S. consumers seemed willing to pay a premium for higher-quality goods at supermarkets. CPG companies have certainly predicated parts of their go-to-market strategies on this assumption. But a strategy based on premium products is hard to sustain, especially in periods of economic weakness. The fact is that per capita spending on grocery store products in the U.S. basically hasn't budged in 50 years;[1] the growth that CPG manufacturers have gotten in that time has mostly been a function of population increases. That makes the slow population growth that's expected in the U.S. over the next decade (with the exception of two ethnic groups, Hispanics and Asians) a problem for manufacturers.

Besides the specter of low population growth, the two most significant threats to food and packaged goods companies are the bifurcation of the consumer base and the fragmentation of retail formats. Together, these two developments are prompting manufacturers to spread their bets and diffuse their energies, putting pressure on margins.

The most significant threats are the bifurcation of the consumer base and the fragmentation of retail formats.

Bifurcation refers to the split that has become apparent in recent years between consumers willing to pay more for higher-quality food and other packaged goods (a demographic that we call "selectionists") and consumers cutting back and looking for value ("survivalists"). Before the 2008 financial crisis, there were roughly equal numbers of the two groups; if you looked at a statistical distribution, it would have resembled an hourglass. In the past few years, however, the number of selectionists has fallen; a far greater number of people (about two-thirds of all U.S. consumers) are now survivalists. Outside of a few product categories with high levels of consumer engagement (coffee is one example; baked goods is another), there is simply less interest in paying a premium. Given the realities of the U.S. economy — especially the high unemployment and underemployment that have persisted since 2008 — it is unclear when or if a preference for higher-priced goods will reemerge.

The problem with *retail format fragmentation* is that it forces CPG companies to support multiple formats. Long gone are the days when manufacturers mostly had to worry about winning with grocery stores. Our forecast has the grocery channel share of all packaged goods sales falling from about 45 percent today to about 37 percent in 2025 (*see Exhibit 2, next page*). What's more, grocery executives are not likely to reduce capacity — if historical patterns hold true, they'll *add* capacity in geographic areas that are growing, while delaying expensive store closures in areas that are struggling. By our estimate, traditional groceries will account for almost half of the additional 345 million square feet of capacity in all retail formats by 2025. This will result in overcapacity and will contribute to what we expect will be a marked decline in productivity by 2025; if you think the center of your local supermarket is a dead zone today, just wait. Yet most CPG companies have not yet systematically rethought their relationships with grocery stores, opting to add support for as many new channels as they can while maintaining the bulk of their grocery trade activities at previous levels. In our opinion, this approach will prove unsustainable.

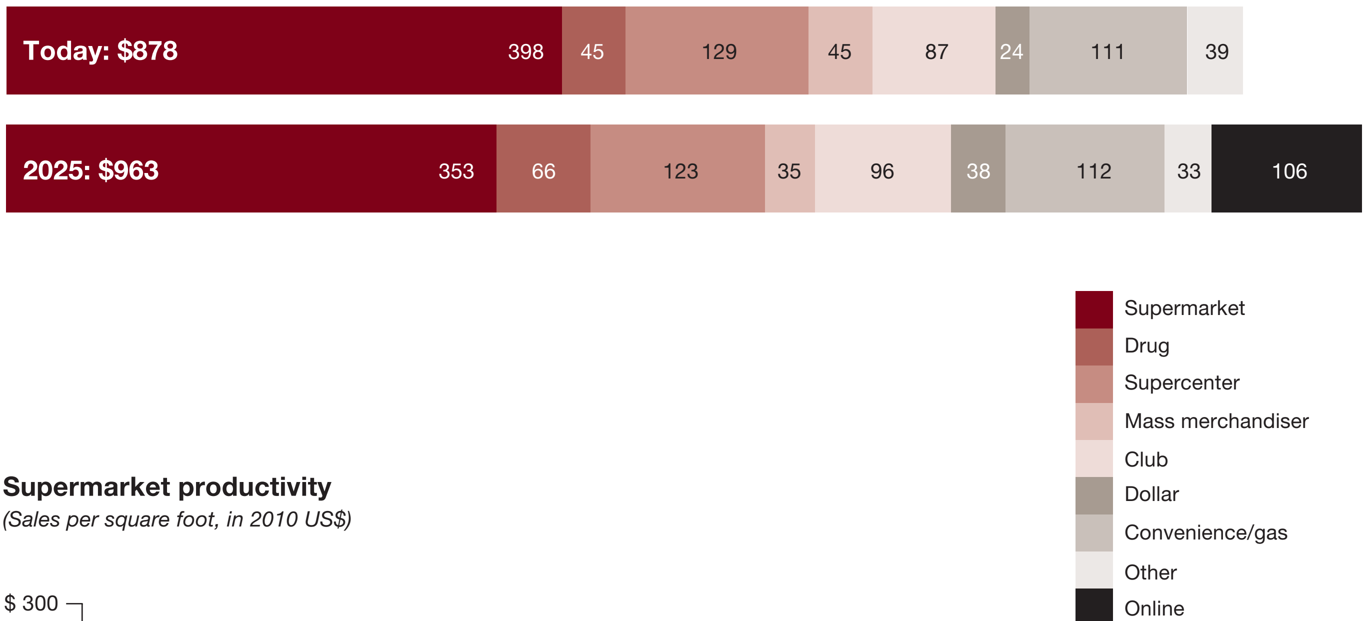
A third radical change in the landscape — the one that probably gets the most attention — involves technology. Manufacturers need to adjust to a world in which consumers use price comparison services such as Southern Savers to figure out where they can get the best deal on things, and in which some consumers are starting to buy grocery store products online. From a volume standpoint, it's unlikely that e-commerce will become as big a channel in grocery products as it has become in books or electronics products — grocery products have special challenges due to their fragility, perishability, immediacy, and bulk. But with consumer buying patterns continuing to shift, online is certainly not a trend that CPG manufacturers can afford to ignore. We project that e-commerce will account for 11 percent of all grocery sales by 2025. We don't have a clear picture of which retailers will be most prominent in the online grocery channel, but with more e-commerce players (including Amazon) signaling that they will carry grocery items, we would be surprised if much of the sales in this channel didn't go to new players.

The advantages of scale have diminished.

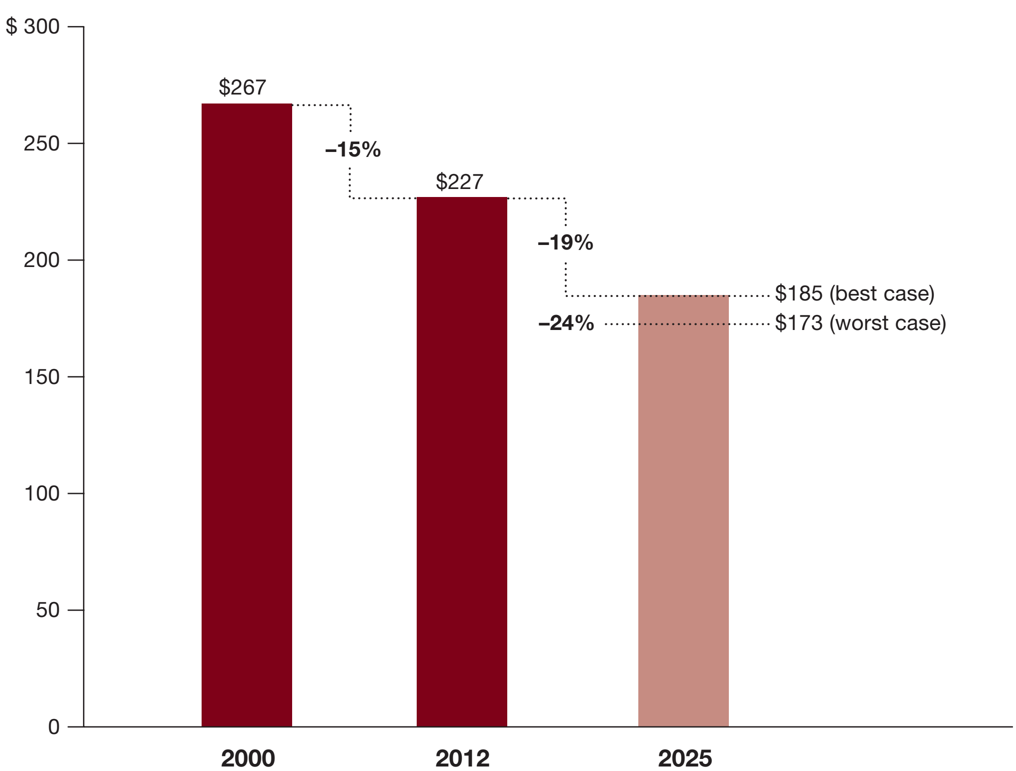
Large CPG manufacturers used to be able to take advantage of their scale to win in the market, capitalizing on their geographic footprint to get the widest distribution, and on their financial strength to saturate television with ads and create brand awareness. But in an era when powerful retailers like Whole Foods Market and Walmart are actively pursuing relationships with smaller food and beverage suppliers, and when marketing campaigns are becoming less dependent on TV (and thus more affordable), the advantages of scale have diminished.

Exhibit 2
Traditional supermarkets will see productivity decline further

Grocery share by channel*
(US$ in billions, adjusted to 2010)



Supermarket productivity
(Sales per square foot, in 2010 US$)



* Online sales are deducted pro rata from club stores, mass merchandisers, supercenters, and supermarkets. Numbers may not add up due to rounding.

Source: Strategy& analysis

Six strategic responses

There are six adaptations that manufacturers can make in response to the changing environment. Not all of the adaptations will be equally relevant to all CPG companies, but most will have some relevance, and many will require strategy adjustments and changes to companies' capabilities systems. Here's a closer look at the things that CPG companies should consider.

1. Reassess and fine-tune the portfolio. In the past, when the number of selectionists was larger, it was possible to thrive with a strategy (and capabilities system) built mostly around premium products. Today, in the era of "everyday low prices," large CPG companies built around the appeal of premium products may have to rethink that positioning.

Procter & Gamble is a good example of a company facing this challenge. Historically, P&G has maintained a heavy investment in R&D and built megabrands that consumers saw as being superior in their categories — more durable, more effective, more reliable. This is the story of brands like Charmin, Bounty, and Pampers. But with increased consumer sensitivity to price, P&G has had to extend into the value segment, where it hasn't traditionally been as strong. Bounty Basic and Charmin Basic are now just as important as the original (and more expensive) versions of those products. Luvs, a less expensive brand, has supplanted Pampers as P&G's priority in the diaper category.

One question for any company trying to position itself at an additional point on the value spectrum — the need could just as easily be for a new premium product as for a new low-priced one — is the company's ability to develop the necessary capabilities to support an expanded portfolio. The idea isn't simply to "blanket the market" by adding more products; it's to make a few carefully considered new bets, while eliminating parts of the portfolio that may be redundant or that lack a clear position. The challenge for manufacturers is figuring out exactly what products they need to maximize their sales with different consumer segments. (We will have more to say about this on page 14, in the section about price-pack architecture.)

The idea is to make a few carefully considered new bets, while eliminating parts of the portfolio that may be redundant.

2. Win with complexity. For a decade or so after supermarkets lost their dominance, CPG companies only had to worry about one new format, the hypermarket, and its popularizer, Walmart. If a manufacturer could produce a version of its products that met Walmart's specifications and that the fast-growing retailer wanted to carry, the profits would follow.

Today, from a manufacturer's perspective, Walmart (though itself still relevant) conjures up a bygone era that seems almost simple in retrospect. Now, manufacturers must have different versions of their products to sell in various retail formats, from club stores to dollar stores to supermarkets (*see Exhibit 3, next page*).

And it isn't only the packaging that changes as manufacturers set their plans for different retail formats and banners. Institutional brands may need to be rethought to appeal to retailers' increasing environmental awareness, and product formulations might have to be tweaked as part of the same exercise. For instance, a food company that has a chance of getting onto the shelves of Whole Foods, one of the fastest-growing independent grocers, might have to make changes that appeal to shoppers who buy organic or artisanal products, and who want to know that what they're getting is "non-GMO" (that is, free of genetically modified organisms). In the increasingly important club format, getting distribution at Costco may likewise require offering something not available at Target or Walmart. Smucker's came up with a clever solution to this when it retrofitted jams it sold in Canada, with a 5 percent higher fruit content, to the Costco format. That allowed Smucker's to sell jam at Costco for a few pennies more than it might otherwise have been able to do. But it did not spare Smucker's the challenge of supporting a new SKU. It meant more complexity.

Manufacturers must have different versions of their products to sell in various retail formats.

The need to fit into more retail formats, and provide different versions of products for different banners, has significant implications for companies' supply chains. Specifically, it is no longer enough to have a highly standardized, highly efficient supply chain; companies also need tailored business streams and more flexible, faster supply chains. To maintain these assets in parallel is a significant challenge and requires new capabilities.

3. Develop a true channel strategy. One takeaway from the declining importance of traditional grocery formats might be that manufacturers should cut back on their trade activities at these stores. But that's a little like advising an executive who has a US$5 million stock bonus vesting in a few months to forget about the bonus and leave for a new company that's wooing her. Likewise, most CPG companies still have a lot at stake in their relationships with traditional supermarkets. They need to

Exhibit 3
Some manufacturers now offer a tailored product offering for specific channels

Example: Major detergent brand

	Costco	Walmart	Giant Eagle	Family Dollar	Home Depot
Size	170 oz. (110 loads)	150 oz. (96 loads)	150 oz. (96 loads)	100 oz. (64 loads)	150 oz. (96 loads)
Formula	Original	2X Ultra	Original	Original	Original
Retail price	$22.07	$17.97	$19.99	$14.00	$23.99
Price/load	$0.20	0.19	$0.21	$0.22	$0.25
Price/ounce	**$0.13**	**$0.12**	**$0.13**	**$0.14**	**$0.16**

Note: Prices are in US$.

Source: Strategy& field study and analysis safeguard their near-term interests even as they're preparing for their next moves.

The need to maintain distribution through traditional grocers does not mean that CPG manufacturers should keep doing whatever they did in the past. Club and dollar formats are rising rapidly in importance, as is online, and to the extent that this is true for a specific CPG company, that company should start shifting more of its attention to those channels. At this point, probably the worst thing a CPG manufacturer can do is to allocate its trade budget using some sort of historical approach, with incremental adjustments based on the previous year's spending. The best approach is to move more toward something resembling zero-based budgeting. Indeed, we are working with some major U.S.-based CPG companies that have done just that. These companies have become much more scientific in their approach to segmentation — it's an enhanced capability that they've deliberately developed. Their conclusions are influencing their trade-spending allocations, the time and management attention that different accounts get, and their willingness to invest in innovation on behalf of specific formats and partners.

Club and dollar formats are rising rapidly in importance, as is online.

4. Help your customers win through innovative merchandising. CPG manufacturers used to define innovation as product-line extensions. As shoppers, we all notice when a product we like comes out in a new variation. If we like a juice manufacturer's lemon-lime drink, we take notice when the manufacturer adds variations that feature guava, pineapple, strawberry, and blueberry.

But this is very much a strategy for the center of the store — and the center of most grocery stores, as we've already said, is getting less and less traffic. The products on the shelves in the middle of most grocery stores are also the products most prone to disintermediation online. We can all go online to buy pet food and tin foil and dishwashing liquid and dry cereal and jars of jelly for our pantries. And many people will do just that in the future.

Increasingly, the important innovations relate to what's happening on the periphery of the store. This is where the action is — it's where you find the prepared foods and fresh produce and flowers — and it's where the money is now made in groceries. To succeed here has more to do with selling ideas and solutions than items, and is thus going to require some new capabilities on the part of CPG manufacturers. They'll need to somehow make a case for themselves as being integral to "occasions" — whether the occasion is something that happens once a year, like Thanksgiving or Valentine's Day, or that happens daily, like breakfast.

Innovative merchandising may also refer to a CPG company's ability to innovate in how it connects with shoppers or uses data and analytics. These areas, too, require augmented capabilities.

5. Position for success in digital. No CPG company needs to be told that it should use digital technology to engage consumers. Manufacturers of soft drinks, breakfast cereals, candy, and yogurt are tweeting, setting up Facebook pages, sponsoring interactive events, and sponsoring real-world events and then letting people interact with them online. Digital has become part of the CPG industry's consumer engagement strategy, with some great early results.

E-commerce is another story. The products of many CPG companies don't lend themselves to online sales. In many cases, their bulk makes them too expensive to send via existing parcel services; in other cases, the fragility of the products means they run a high risk of being damaged in transit. Some companies are working on packaging innovations to give their products a better chance of surviving an overland delivery process, but the economics are still unfavorable. There is a reason that grocery products have been so late to come online.

The right approach to digital for now is likely to develop a flexible plan that looks out two or three years.

Still, along with club and dollar stores, online is one of the formats that must be addressed if a CPG company is to have a chance of winning in the complex retail environment that is emerging. Amazon, for instance, is in the process of opening 70 new distribution centers, many of which will carry food. There will also be omnichannel players (retailers with both online and physical stores; Walmart and supermarket chains are the likeliest examples) that will require different SKUs for their different formats. It would not be surprising if these omnichannel players looked at the early trade agreements they have with manufacturers online and said, "You know what, we want those same terms for our bricks-and-mortar stores." Retailers' interest in having comparable trade terms in different channels is understandable. But a policy of matching terrestrially what one is offering online could wreak havoc on the economics of manufacturers' businesses.

The right approach to digital for now is likely to develop a flexible plan that looks out two or three years. Most of the near-term activities would continue to be about marketing communications and about collaborating with the retailers, like Amazon and Walmart, that are likely to become most influential online. The initiatives that are further out can be more directly focused on e-commerce, such as new fulfillment models and direct-to-consumer offerings. These more distant initiatives can be set up as experiments with the necessary capability investments accelerated or delayed depending on the results and on what's happening in the market.

6. Take new approaches to the price-pack architecture equation. Historically, CPG companies have been adept at pricing their products in ways that keep one channel from cannibalizing another, and that maximize their overall “take.” But with the number of SKUs at most CPG companies having grown exponentially with no corresponding increase in consumption, product managers and senior executives now recognize that their aptitude for this bit of problem solving has led them into a trap of their own devising.

In this era of complexity, a primal approach to price-pack architecture, radically simplifying a given company’s SKU assortment, isn’t feasible (though reintroducing original packaging, used early in a company’s history, around the Fourth of July could work in the periphery of a grocery store and is an example of what we mean by doing innovative merchandising and of “owning an occasion”). But even if companies can’t go back to a handful of SKUs, they can cut down on them and home in on the smaller number necessary to succeed in the key retail formats and to meet the expectations of both survivalists and selectionists. Less a new capability than a reengineered one, this approach to price-pack architecture, like the other adaptations we’ve been discussing, is about making choices in a world that’s no longer so black-and-white.

Conclusion

What to do and how to do it? Successful companies constantly ask themselves these questions. Kraft Foods' decision to split itself in two was a recognition that the capabilities needed to succeed with certain food products like prepackaged macaroni, processed cheese, and cold meats were very different from those needed for the company's instant-consumption products (mainly snack and confectionary brands, which are now part of the spin-off company, Mondelēz International).

Not every company is going to do something as dramatic as Kraft, whose change involved making decisions about dozens of high-profile brands, dividing up almost $50 billion in revenue, and transferring some 100,000 people to a new corporate entity. But all companies face the same obstacles to success in North America: the bifurcation of consumer behaviors, the proliferation of retail formats, and the disruptive influence of digital technologies. To win, companies are going to have to figure out how they can play in this new world, the capabilities they'll need, and the products it will make sense for them to maintain. This is the challenge of coherence. The manufacturers that meet it will be best positioned to get back on the road to growth in the always critical U.S. market.

Endnote

[1] In 1965, the average U.S. household spent the inflation-adjusted equivalent of $2,041 per person on food at home. A forecast by Strategy& suggests that number will be $2,061 in 2015 — a change of less than 1 percent in 50 years.

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