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The future of grocery—in store and online

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As so much of everyday life moves to the Internet, including grocery shopping, grocers must find profitable ways to revive the in-store experience while enhancing online options.

No longer do consumers have to peruse ten aisles of products at a grocery store to get ingredients for dinner or restock the cupboards—but for grocery retailers, that's both a blessing and a curse. In this episode of the *McKinsey Podcast*, McKinsey partners Louise Herring and Jessica Moulton speak with McKinsey Publishing's Monica Toriello about how grocery retailers can reinvigorate the in-store experience for customers while also making the most of the shift to online food shopping.

Podcast transcript

Monica Toriello: Hi, I'm Monica Toriello, an editor with McKinsey Publishing. Thanks for joining us. Our topic for today is one that I think most people will have an opinion about because it's something that people do fairly regularly, and that is grocery shopping.

More specifically, we'll be talking about the future of grocery: how stores will change, how the shopping experience might be different, how consumers' purchasing habits will evolve, and how the grocery business could adapt and innovate. Here to share their expertise with us are two McKinsey partners based in the London office. They've been studying the global grocery market for several years now.

Between the two of them, they've worked with retailers on almost every continent. We have Jessica Moulton, who moved to the UK from the United States in 2010 and now leads our Consumer Practice hub in the UK and Ireland. Thanks for joining us today, Jessica.

Jessica Moulton: Thanks for having me, Monica.

Monica Toriello: Louise Herring is from the UK but has served retail clients all across Europe. We're glad to have you here with us, Louise.

Louise Herring: Thanks, Monica. Really happy to be here.

Monica Toriello: Let's start with the basics of grocery retailing. It has always been a tough business: thin margins, high fixed costs, perishable products with different handling requirements, different temperature requirements, and so on.

And it's different everywhere, so what works in the United States doesn't necessarily work in the UK or in Japan or in Africa. But is it fair to say that the grocery business has gotten even tougher in recent years?

Louise Herring: It really has. And in many markets, as the competition has increased. Discounters, in particular, have proved a success story across multiple markets and are continuing to take share, fast. Even in the UK, where they've been late to the market, they've really cracked the formula for growth in recent years.

In addition to that, those new technologies, a proliferation of supply of different formats, and all of that, means that customers have more choice of where to shop. Together, with increasingly busy lifestyles, this leads to fragmentation of where they shop—that all the grocers have to respond to.

Monica Toriello: Let's look at the UK grocery sector in particular. As you've said, there's pressure on revenue due to intense competition, and grocers have high fixed costs. And in turn that leads to cost cutting, which has hampered innovation. I've heard you describe this situation as a downward spiral. Is that downward spiral happening in all developed markets? Or is that unique to the UK?

Jessica Moulton: It's happening in a number of markets, but I think the grocery challenges in the UK are particularly acute for a couple of reasons. The first is because the UK was very early to the online trend, and the second is because it was very late to the growth of discounters in Europe. As a result, we have a set of players here who once had industry-leading profit margins, but they've now dropped by 40 percent. That means that the current ROIC [return on invested capital] of the industry is about half the cost of capital. To put that in perspective, the ROIC at a fast-moving consumer-goods company is typically around 15. Today here in the UK, it is about four. That's a dramatic change in a short period of time.

What we face in the UK is really quite an acute problem of operating-model deleverage because of how high the fixed costs are in retail. So, for every pound that a grocer loses, it doesn't just lose the two pence of profit. It actually loses 24 pence. That's a 12-times multiplier, very difficult for the retailers to manage.

Monica Toriello: Those numbers are stark. One of the ways to reverse this downward trend is what you've called "supersuiting" employees—dramatically improving their productivity, basically through technology. What are the most promising technologies that you've seen in action at grocery retailers?

Louise Herring: There are a whole range of technologies available. It's not just in those immediately obvious places. For example, automation and robotics is a powerful lever to pull both in the back office as well as in stores. If I start with the back office as an example, robotic process automation, which is where code is used to run repetitive, rule-driven work, has been a big trend in financial services.

If you look across industries, there's real applicability in the head-office functions and retail as well. The numbers can be big—30 to 60 percent time savings on applicable tasks. So when you combine that with advanced analytics and the rise in technologies there, that actually gives employees the supersuit that we refer to, and a chance to really focus on what matters.

In stores, there's a whole plethora of technologies becoming available as well. You have shelf-stacking robots and store-cleaning robots—the types of technologies trialed through Amazon Go. The returns are all available there, but retailers are in the process of thinking through how to plug those into their IT infrastructures and their road maps. And really, to work out, do they want to be leaders or followers in that game.

Monica Toriello: Talk a little bit about robotic process automation in the back office. It sounds like retailers have been a little late to the game on that. Why is that, do you think?

Louise Herring: I'd flip it and say it's more that financial services have been the first adopters rather than that retailers have been late. Financial services lends itself to this—because the costs are particularly high, and many of the processes are more standardized—so there's a more obvious immediate opportunity in automation. When you look across some of the functions, such as finance to pick on one, there's no reason why some of the technologies that can work in a financial-services world couldn't also apply to many of the retailers that we have around the world.

Jessica Moulton: I'd suggest there are a number of retail-specific functions that could be transformed by this as well. Obviously, a lot of category-management organizations have a lot of their time eaten up with repeatable processes. If they could automate a higher percentage of those, they could spend a greater percentage of their time on things that would add value to the business and their customers.

Monica Toriello: Louise, you mentioned Amazon Go—it's this concept of having no people at checkout, no cashiers at all, right? You walk in, you pick up what you want, and you walk out. I know they've run into some hiccups. But is that where you see retail going?

Louise Herring: The important thing as far as Amazon Go is concerned is that they're looking to answer the right question. They aren't thinking about how you take just another second off the checkout experience—which has been the focus of the past, and has real value attached to it.

They've asked the question, "How do you remove the checkout entirely," which has massive benefits, both on the labor task—30 percent of the labor task in store—and also it's one of the top pain points in the shopping experience of the customers. It's the right question to be asked and the right approach. Which is the right technology? Only time will tell. But it's the place to be focusing.

Monica Toriello: One other thing you've done is prodded retailers to take a long, hard look at their real-estate portfolio. What are some examples of companies that have made creative use of their real estate?

Louise Herring: If you take one of the most immediate levers, and an important one is to put tenants in stores—and that's something that is a lever that's being pulled by many of the UK retailers today—it adds services to customers and it's an income stream to the retailers, both. It's something of a win-win. Some of the intriguing recent developments in the market, however, are where the retailers are putting residential in as part of their offer. That's incorporating the development of hundreds of flats with rebuild, for example.

What's exciting about that is it creates real value for the retailer, it gives some capital to help fund the right-sizing of the portfolio and of the stores, and I think provides at least part of the solution for the current housing shortage in the UK. The real question then becomes, "How big can you go?"

We think that the retailers need to look across their entire portfolio with this type of thinking to unlock the values, to deal with the tail of more challenging stores. Most likely that will need partnerships in order to do that at scale. Land developers have the balance sheet to make change happen; they have the capabilities and relationships with local authorities to help the retailers extract maximum value at pace.

Monica Toriello: Let's talk about online, because e-commerce has been a factor in grocery, mostly in the UK and in France. Do you think those countries will be maintaining their leadership position in that arena going forward?

Jessica Moulton: Yes, we think the UK and France will maintain their leadership positions, but that's because they're so far out in front. Meanwhile, we expect there'll be considerable growth in online grocery in other countries as well. The reason for this is because of the clear consumer demand for it. In the UK, online has been growing at 10 or 12 percent for many years, and we see no signs of that changing. It's going to grow at a similar rate for the near future. The consumer demand is super clear, especially among families and among millennials, so this trend will continue. The real challenge in the space is the economics to the supply. The UK is different because the competitors all rushed when they saw each other entering the market. That hasn't happened in many other markets around the globe. We suspect that we will see more competition coming into this space as technology reduces the cost to delivery and the cost to pick, and frankly, as the grocery market continues to mature and competitors feel that they need this source of additional growth.

Monica Toriello: Delivery costs remain high. The last-mile challenge remains a big one. What are some of the innovative ways that retailers have risen to that challenge?

Jessica Moulton: First, let me spend a moment on the financial challenge. For each 80-pound basket, grocers have to pay about five pounds for someone to pick the items off the shelf, and at least another five pounds for someone to deliver it—so that figure is higher, maybe around eight pounds. Obviously, 11 pounds or more is far more than the delivery fee.

This is quite a challenge for the grocers. They've attempted to solve it through a number of means. The biggest one is by trying to increase drop density. There are some interesting models out there that assist in this. One we think is particularly interesting is the milkman model, which is being used by a small company called Picnic in the Netherlands, that offers only two slots per week to the customer instead of the typical 24 or 32.

With that kind of reduction in choice for the customer, they're able to get their drop density up to 14 drops per hour, which is seven times higher than the UK average. That's quite transformative. There are a number of models out there. We think we'll see a lot more activity in this space, particularly as third-party delivery companies continue to evolve and develop and are able to offer increasingly dense networks.

We're experimenting in China, where Digital McKinsey is developing an app that's helping merchants link up with logistics companies and also trucking fleets in order to share their capacity.

We think this will allow fleet costs to be reduced by as much as 30 percent. It'll also avoid cancelled orders and other customer frustration.

Monica Toriello: One of the things that's interesting is food-related digital engagement, which is very high—whether it's people watching cooking shows or how-to videos or sharing recipes online. And certainly, people seem more interested in their food than they've ever been before. What are some ways, do you think, that grocers can capitalize on this?

Louise Herring: That is one of the biggest questions facing the grocers right now. As you say, people are really engaging. But, on the other hand, only 15 percent of customers say that they actually enjoy food shopping. That's at the heart of one of the aspects that needs to change. To do that means bringing innovation into the market, finding new ways to engage customers, and helping them rediscover the joys of shopping.

Retailers can take inspiration from the digital world and from the design world, and use principles to pick up the pace of the innovation that they're trying in store, and the reliability of that innovation. By that I mean create ideas at pace, quickly build multiple ideas to test, use stores as real-time test beds, throw ideas away fast, and replace them with new ones where they don't work—making sure that they're critically identifying and scaling the gems that drop out of that process.

Doing this well means bringing together a whole bunch of areas of expertise—customer insights, store-operations experts, and even people who are capex [capital expenditure] experts—to think about how to do all of this in as lean a way as possible, and to make sure that any ideas that are scaled are tenable, given that there's a cash-constrained world right now.

Jessica Moulton: Many grocers are facing price pressure—as we have discussed—from many different angles. Many of their responses have been to therefore take a lot of the joy of discovery and innovation out of their stores. The big answer here is to look to return to it, in cost-effective ways and in wise ways, doing plenty of testing and learning to make sure there's no overinvestment.

It is really important to bring more innovation back. We suspect that consumers are looking for it, craving it, even. We know that online is not a great place for food discovery. It's hard to imagine how it ever will be. Most discovery, particularly of fresh, will have to happen in person. That's a great sustainable competitive advantage for the grocers. We suspect there's a lot of opportunity for them to reembrace that and bring more innovation back into the store, more excitement, more day-to-day enjoyment of food. Consumers are clearly telling us that food is important to them. We think this means there's more opportunity for grocers than they're using today.

Louise Herring: In terms of gems, I think if you look abroad, you can start to see some of the ideas. For example, in the Netherlands, having displays of products for inspiration for "dinner for tonight"—where you can pick up all the components in one go, and make it very easy for customers running in and out, and also with little preconception of what they want, other than a nice meal. In the States, food service, I think, has been taken to a different level to what you would see here in the UK. There's so much demand for immediate food, food for tonight, that that has to be an exciting area to examine.

Monica Toriello: How concerned do you think retailers should be about manufacturers going direct-to-consumer?

Louise Herring: We'll see more of this, particularly in the higher-margin categories, which, of course, puts the grocers under more pressure.

Because really, the underlying question becomes, "What's best for the consumer?" The big shifts that you get in online hinge around delivering price advantages, reduced friction, or both. If those factors are there for going direct, whether overall or to certain customer groups and in certain occasions, I would expect it to scale. From a retail point of view then, it becomes critical to keep the customer front and center—and be clear on where they're adding value and where there are challenges that they need to innovate their way around.

Jessica Moulton: Any category with high emotional engagement from the consumer is more likely to go direct-to-consumer. The industry we see changing the fastest in this space is beauty. Vitamins are very online these days. But there are sets that will not go online, or at least will be real laggards in doing so. They can be mainstays for the traditional grocers. Fresh is the obvious category of critical importance. It always has been central to grocers' success. We think it'll only be more so over time.

Monica Toriello: Can either of you talk about a personal experience that you've had in a grocery store or with a grocery retailer that you feel embodies the kind of service or the kind of experience that consumers should have on a weekly basis as they do their grocery shopping?

Jessica Moulton: One of the great strengths of grocery is it's a part of most consumers' weekly lives. It's a weekly shopping experience, maybe it's more frequent than that. Well, it's taken on a particular importance in my household, because my three-year-old has decided that she's just fallen in love with grocery shopping.

We now have a new Sunday tradition where my three-year-old and my six-year-old both get to choose three items in our local grocery store. It's such a pleasure, because we end up going at the same time every morning, and so some of the same staff members who are there now recognize my three- and six-year-olds, and they greet them and encourage them as they make these three powerful choices. It's such a neat example of how a grocer can be a part of a family's weekly experience. It's really important to my three-year-old. But you know what? It's really important to me, too.

Louise Herring: For me, in grocery shopping, it's so many of the little things that matter. When our home shopping is delivered, I can hear the difference it makes when my husband opens the door—and I'm desperately juggling the baby upstairs—that the delivery man is so polite and so enthusiastic to see my husband and hand over the food. It makes a big difference.

The question for me is how to get those little moments throughout the store.

Monica Toriello: What do you think is the most important piece of advice that a grocery CEO should keep in mind?

Jessica Moulton: It's that you have to move, and it might sound a bit trite, but the consumer is changing fast. We see a lot of grocers not keeping up with that rate of change. But they have a tremendous base of assets to leverage, a lot of competitive advantage, a lot of staying power, and they also have the great benefit of grocery shopping being a weekly occurrence.

This is a category in which you get trial and retrial, and you get to come back to your consumer and get them to reevaluate you. We think a lot of grocers could be doing more—focus on the love consumers have of the food categories they're in and on all the competitive advantages that they have in sourcing and in delivering a great in-store experience, and take that further.

Louise Herring: This is not a market where you can shrink to greatness. So the real question is, what is the unlock? What is the innovation that's going to keep customers engaged, as Jessica was just describing, and make them re-love shopping.

Monica Toriello: That's a lot for grocery CEOs to think about. We'll end here. Thanks very much, Jessica and Louise, for your time today. And thanks to all of you for listening. For more of our latest thinking on the retail industry, please visit McKinsey.com. □

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