McKinsey & Company

Navigating market headwinds: The state of grocery retail 2022

Southeast Asia

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Foreword

More than two years after the start of the COVID-19 pandemic, and as post-pandemic economic recovery is clouded by additional headwinds, the grocery industry continues to face disruption. This is even more apparent in Southeast Asia, where both pandemic-related disruptions and more recent inflationary pressures appeared in a time of increasing growth and digitalization in the industry—accelerating some preexisting trends and putting pressure on profits for retailers that are already investing in growth.

While some themes shaping the sector—such as the growth of e-commerce—have continued throughout this period, additional headwinds are once again testing the resilience of grocers and the food industry as a whole. Executives have expressed some uncertainty about market conditions in 2022, pointing to lower profit margins, heightened competition, a difficult profitability equation in omnichannel, and rising inflation looming. These trends, as well as global events, are likely to have only a greater influence on consumer confidence and spending.

Moving further into 2022 and beyond, grocers will face growing pressure on margins and pricing as they navigate the need to cater to broader consumer tastes and demands as well as clear signs of bifurcations in consumer spending behaviors (in other words, continued premiumization but also large consumer segments trading down and prioritizing value-for-money). Omnichannel complexity will continue to rise, with consumers seeking more seamless experiences and manageable fulfillment fees.

We recognize the industry faces significant uncertainty. All grocery executives are grappling with a series of questions: As consumer behavior continues to evolve, how can grocers best cater to new trends such as health and wellness and value? E-commerce has become table stakes, but how can grocers continue to enhance the omnichannel experience while improving profitability? How much will they need to invest in automation, and how can they harness technology to change the operating model for stores and employees? As sustainability gains traction, what is the right way to begin the journey or build on existing plans?

This report—the first edition for Southeast Asia—aims to answer those questions. Its contents are part of McKinsey's broader global series, *The state of grocery retail*, an annual publication covering the developments of the grocery retail industry in three regions (Asia–Pacific, the European Union, and North America). Our goal is to frame major trends and issues for CEOs seeking to stay ahead of market shifts. To offer a holistic view of industry dynamics, the report complements insights and analyses from our colleagues with surveys and interviews with grocery executives.

We hope the report will offer new insights that can help grocers, and those in the broader food industry, remain competitive during these unprecedented times.

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Acknowledgments

We also want to extend our gratitude to those across the McKinsey communities who contributed to this research and participated in our State of Grocery Survey. The authors wish to thank Julia Büntig, Kristy Choy, Kapil Joshi, Nicole Lee, An T. Nguyen, and Nadya Snezhkova for their contributions to this report.

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The state of grocery in Southeast Asia

A series of emerging trends will put pressure on modern grocery retailers to adapt. Five “resets” hold the key to continued growth.

by Matthieu Francois, Dymfke Kuijpers, Ali Potia, and Rohit Razdan

The Association of Southeast Asian Nations (ASEAN)[1] presents potential growth opportunities for modern grocery players (Exhibit 1).[2] The region's more than 600 million people spend $200 billion on groceries each year,[3] but traditional trade[4] still accounts for two-thirds of this total—a strong indication that the modern grocery industry has headroom and the opportunity to capture a greater share of shopping needs.

Across ASEAN, overall consumer expenditure is expected to grow about 5 percent in the next year, depending on how global macroeconomic forces affect the region. Underlying demand is higher among urban consumers, who are shifting their spending from fragmented to modern channels, creating strong tailwinds for modern retail. Our analysis projects growth of 6 to 7 percent a year for modern grocery retail through 2025, making ASEAN one

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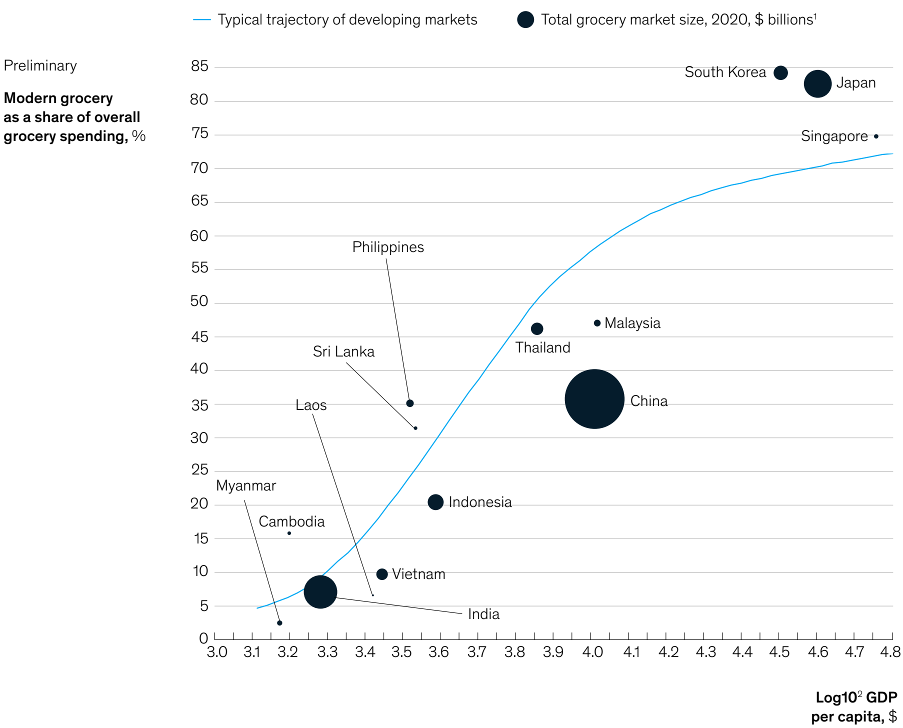
[1] ASEAN members are Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Vietnam.
[2] Modern grocery retail includes supermarkets and hypermarkets.
[3] Retail sales value including sales tax, Euromonitor, 2021.
[4] Traditional grocery retailers are small-scale independently owned stores.

Exhibit 1

The penetration of modern retail tends to follow growth in GDP per capita, with wide variations across Southeast Asia.



[1]Retail sales value, including sales tax.
[2]The Log10 (or common logarithm) is used to simplify the scale for countries with large differences in GDP per capita. For example, log10 of 3 is 1,000; log10 of 4 is 10,000; and log10 of 5 is 100,000.
Source: Euromonitor

of the fastest-growing and most exciting regions in the world for modern grocers (Exhibit 2).

Grocery executives must act quickly to capture their share of the ASEAN market.

Six emerging trends shaping modern grocery

As the industry grows, a number of developments and disruptions will intensify pressure. Modern grocery retailers must be prepared to adapt their strategy to achieve sustainable value creation and compete with fragmented trade, which itself is being reshaped by emerging eB2B platforms. We explore six trends that will influence modern grocery retail in ASEAN in the coming years:

1. Increasingly discerning consumers
The pandemic-fueled rise in grocery retail spending will likely persist even after the pandemic abates. Contributing factors include the transition to hybrid- and remote-work arrangements and the increase in dining at home.

McKinsey research has identified three distinct priorities influencing consumer purchasing decisions (see sidebar, "About the research"). Amid a period of economic volatility, consumers are tightening their belts and actively looking for ways to stretch their resources ("better value for me"). In parallel, they are working to improve their physical wellness and immunity ("healthier for me") through healthy eating, better nutrition, and an increased focus on macro- and micronutrients. A third well-documented pattern is a willingness to purchase food online. (For more, see "The changing face of consumer demand.")

About the research

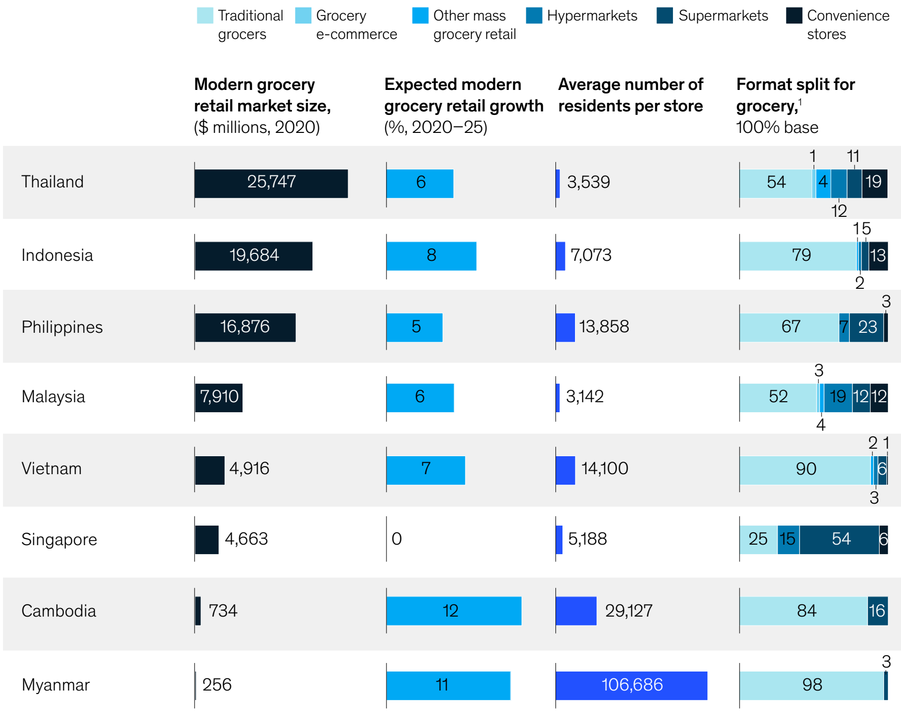
We conducted surveys of 1,003 people in Indonesia and 1,020 people in Vietnam to inform this report. These surveys asked respondents about their shopping habits and expectations, and our analysis focused specifically on modern-trade shoppers. We carried out similar approaches and methodologies in Australia, China, India, and South Korea to round out our research on the region. In addition, we drew on the McKinsey Indonesia Consumer Pulse Survey, which included about 1,000 respondents and was conducted periodically from March 2020 until August 2021. The survey explored consumers' thoughts about their overall economic prospects.

We augmented these surveys with case studies assessing company financials from our client work (when publicly available), interviews with retail executives in each of the ASEAN markets to understand their strategy and profitability, and other elements.

In the years ahead, these behaviors could become more entrenched. Consumer spending is projected to rise through 2023 and will likely be accompanied by more sophisticated purchasing behavior.

Exhibit 2

The Association of Southeast Asian Nations (ASEAN) continues to provide growth opportunities for modern grocery retail operators.



Note: Figures may not sum to 100%, because of rounding.
[1]The grocery 100% split has sales of food and drink e-commerce (grocery e-commerce) added in the overall grocery market to arrive at a breakdown by various formats.
Source: Euromonitor

2. Fierce competition from ecosystem players

Most grocery retailers are well acquainted with increased competition from traditional players. Potentially more threatening is the rise of ecosystems and digital players with value propositions that could erode the competitive advantages of physical retailers. For example, mobility and e-commerce aggregators tend to use grocery categories to drive traffic to their own platforms.

Retailers face a vexing dilemma. By ceding core consumer interaction points to these players, they could gain a revenue source but lose out on their most precious assets: data on consumer behaviors and the ability to attract and retain consumers by creating a great experience. However, a lack of collaboration could also lead some aggregators and platforms to monetize this access (for example, with retail media networks[5]) before retailers do.

[5] Marc Brodherson, Jon Flugstad, Quentin George, and Jack Trotter, “Busted! Five myths about retail media,” McKinsey, June 7, 2022.

3. A shift from growth to profitability
In many ASEAN countries, modern retail has achieved rapid growth before becoming profitable. While retailers have made remarkable headway toward profitable growth, breaking even remains a challenge, especially in online grocery, and will require new business models.

Modern grocery is expected to become prevalent in core urban areas in ASEAN over the next decade. This saturation will lead retailers to explore two new sources of growth. First, they will innovate and reorient their prepandemic customer value proposition to keep pace with new preferences. Second, they will increasingly seek to find sources of profitability, such as maintaining gross margins through negotiations, rationalizing store networks thoughtfully, or embarking on broader cost reduction initiatives. (For more, see "ASEAN grocery: Balancing growth with profitability.")

4. Fresh offerings under pressure from digital players
Larger-format modern retailers have distinguished themselves with fresh offerings (fruits, vegetables, meat, and seafood) that are competitive on not only price but also quality and assortment. To balance quality, price, and profitability in fresh offerings, modern retailers must overcome several challenges, including securing stable, high-quality sources and maintaining consistent quality across outlets and through different seasons.

Competition is increasing: fresh produce can be purchased through e-commerce or more specialized small-scale niche supermarkets. These channels are particularly popular in countries with more mature infrastructure, such as Singapore, as well as in emerging countries like Indonesia. (For more, see "Building a compelling fresh proposition.")

5. Competing demands on omnichannel
According to our ASEAN consumer survey, e-commerce penetration in grocery, while still low, continues to grow rapidly as consumers prioritize convenience, safety, and promotions. Although consumers are embracing omnichannel, the economics remain challenging for retailers. On the one hand, the main goals for start-ups are increasing gross merchandise value and boosting user acquisition and retention. On the other hand, consumers are demanding more, and they still believe delivery charges are too expensive.

As observed in other geographies, retailers will have to refine their omnichannel positioning to strike a balance between rising consumer expectations and difficult unit economics. Options include online offers, click and collect, and partnerships with digital players. (For more, see "Crafting an omnichannel value proposition in the wake of the e-grocery revolution.")

6. A growing emphasis on sustainability
Consumers, investors, regulators, and nongovernmental organizations are pressuring companies in the food system to take tangible steps toward sustainability. Asian consumers are expressing concerns about climate change and show an increased willingness to shift their spending habits accordingly, so grocers must develop strategic sustainability transition plans. ASEAN has much catching up to do on issues such as plastic packaging, the race to net-zero emissions, and social equity. And customers, employees, and investors will increasingly hold retailers accountable for their environmental footprints.

This challenge is exceptionally complex—for instance, in the race to net zero, emissions generated from the average retailer's own operations, together with purchased electricity and heat, are responsible for just 4 percent of the total footprint. Moreover, getting rid of plastics or making more "healthy" recipes requires consumers to fundamentally change their behavior. Retailers should view the elements of these plans primarily through the lens of value creation, since a large portion of the levers for a sustainable transition would also improve EBITDA or significantly mitigate risks. (For more, see "How grocers could use sustainability to transform Asian food systems.")

The way forward for retailers: Five 'resets' for success in the next decade

Amid these significant disruptions and additional challenges, grocery retailers must move beyond focusing on factors that enable them to excel at traditional retail, such as clear value proposition, distinctive format, fresh excellence, and efficient operations. They can get started on this journey by pursuing five "resets," which can anchor their transformation over the next decade.

Reset 1: Reframe the playing field to embrace consumer tech

Media, entertainment, food service, and food retail are increasingly converging into a "consumer tech" ecosystem, so retailers need to think like disruptors. Retailers can ask themselves the following key questions:

- Who is our customer?
- What is our distinctive value proposition?
- Where are our inefficiencies?
- Where can we disrupt the value chain and create a better, cheaper, more direct line to the customer?
- In which categories do we have a distinctive edge? How are we positioned in fresh? Beyond fresh, where can we offer customers the best assortment?
- How will retailers gain access to proprietary insights, assets, customers, and suppliers?
- Where can retailers partner using a programmatic mergers, acquisitions, and alliances (M&A&A) approach?

The answers to these questions can help modern retailers distill their competitive advantages and make the right investments to expand confidently beyond their existing offerings.

Reset 2: Double down on fresh, healthy, and private-label offerings before others do

Time is running out before ecosystem players, e-commerce specialists, or niche chains make major incursions into the market. To remain competitive, modern grocery players must develop compelling propositions across several categories. They can win in fresh by gaining the trust of consumers and delivering consistent quality. Augmenting the traditional product portfolio with a variety of healthy and sustainable products will enable retailers to cater to sought-after consumer segments to truly differentiate themselves in the market. Last, as consumers become more price conscious, a robust array of private-label products will help to insulate modern grocery retailers against continued inflation. These efforts require continuous improvement in sourcing and supply chain capabilities, as well as thoughtful choices on assortment.

Reset 3: Digitalize, digitalize, digitalize

Retailers no longer have excuses for not harnessing digital technologies to both elevate their consumer value proposition and improve their own operations. The only way to achieve sustained growth is to get smarter, cheaper, and faster through strategies such as serving the customer 24/7 through an online-to-offline approach, enabling precision marketing through data analytics, or using technology to automate or streamline the value chain. By incorporating data and technology, retailers can double their output and quality at half the cost. Modernizing the underlying tech stack and embracing superscaler methods will be paramount to reach consumers everywhere—and in a personalized way. In a world in which information flows freely, the winner will be the retailer with the best customer experience and the ability to scale fastest, not necessarily the biggest or cheapest retailer.

Reset 4: Pursue new revenue streams and build and scale new businesses

As the industry shifts from grocery to food retail to consumer tech, new revenue streams become available. The strongest example is retail media networks: in the wake of the shift of consumer behaviors toward e-commerce, advertising budgets are flowing toward commerce media, a new form of advertising that closes the loop between media impressions and commerce transactions to improve targeting, provide new audience insights, and deliver more relevant and valuable experiences for consumers.[6] This shift is important for physical retailers, which can capture a share of this spending by developing the right offering. Other opportunities require retailers to take a "business building" lens, which could include building a private-label offering around alternative proteins or launching an eB2B platform. In a recent McKinsey survey of executives, 52 percent of respondents indicated building new businesses was among their top three priorities.[7] Retailers need to determine where they have an advantage and the time left to win and then focus on scaling faster.

Reset 5: Pursue profitable, sustainable, inclusive growth

Retailers must determine how they perform on environmental and social sustainability, where they can distinguish themselves, and what shifts are required in governance, KPIs, incentives, and work processes and culture. They will often find that near-term actions to improve sustainability can increase profitability, while broader and longer-term transformations are needed to meet expectations from shoppers, investors, and partners. To pull sustainability levers, retailers should rethink assortment, reallocate investments (including vertical integration to source

[6] Marc Brodherson, Tiffany Chen, Jon Flugstad, and Quentin George, "Commerce media: The new force transforming advertising," McKinsey, July 5, 2022.
[7] McKinsey 2020 Digital Business Building Survey.

more sustainably), and reinvent operations to minimize their own footprint. In practice, successful transformations need to be anchored in a transparent baseline and a portfolio of initiatives that become part of the CEO agenda.

We hope these insights inspire ASEAN grocery executives to face the future with confidence. Executives have a golden opportunity to transition their organizations from grocery retailers to players in a consumer tech ecosystem. Successful retailers will be well positioned to harness the demand from a growing middle class and shape future shopping behaviors through new experiences and new business models. These elements will ultimately be the key to crafting a path to sustainable and inclusive growth.

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The changing face of consumer demand

Consumers are increasingly seeking value, healthier products, and convenience. Retailers must be prepared to keep pace with these evolving preferences.

This article is a collaborative effort by Kapil Joshi, Clarence Lew, An T. Nguyen, Ali Potia, and Nicole Yee, representing views from McKinsey's Retail Practice.

The pandemic-fueled rise in grocery retail spending will likely persist even after the pandemic abates. Contributing factors include the transition to hybrid- and remote-work arrangements and the increase in dining at home. As grocery demand grows, however, consumers are seeking more value, quality, and convenience. Their spending behavior is also blurring the distinction between ordering prepared food for dining at home (restaurant takeout) and buying groceries for home cooking.

ASEAN consumption continues to grow

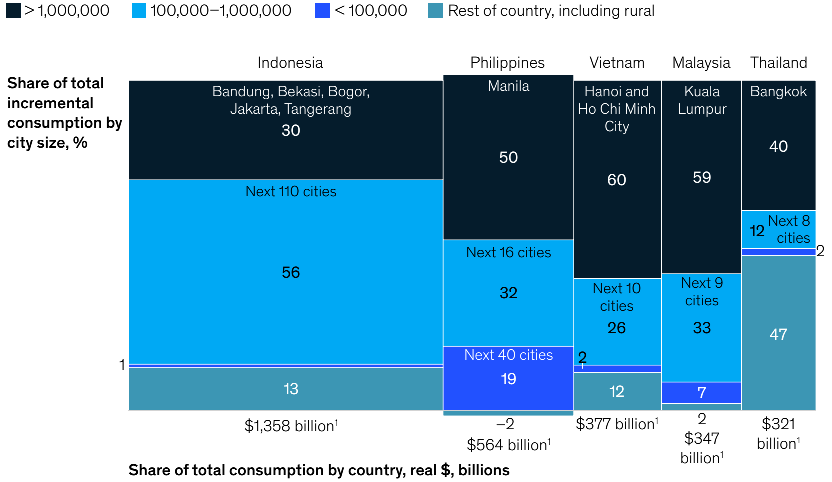
Within the next decade, the Association of Southeast Asian Nations (ASEAN) is projected to become the fourth-largest economy in the world, powered by an expected population of more than 700 million by 2030. The World Economic Forum estimates that domestic consumption, which fuels roughly 60 percent of ASEAN's GDP today, will double to $4 trillion by 2030.[1] While citizens of tier-one cities are expected to account for the majority of consumption, spending outside of major cities will make up close to $1.7 trillion from 2020 to 2030 (Exhibit 1).

Vietnam is a particularly interesting example. Consumption has been largely concentrated in the nation's two major economic hubs, Hanoi and Ho Chi Minh City, which accounted for 37 percent of all Vietnamese households with income of more than $22,000 a year (in 2011 purchasing-power parity). However, our analysis reveals that the number of middle-class households in smaller cities (and even rural areas) is rising at a CAGR of 8 percent, outpacing Hanoi and Ho

[1] *Future of consumption in fast-growth consumer markets: ASEAN*, World Economic Forum, June 5, 2020.

Exhibit 1

Between 2020 and 2030, a significant share of incremental household consumption will come from outside tier-one cities.



Note: Cities ranked per number of households based on 2020 data. Figures may not sum to 100%, because of rounding.
[1]2015 US purchasing-power parity.
Source: McKinsey Cityscope

Chi Minh City, which are at 5 percent. Moreover, the Mekong River and Red River Deltas, which are densely populated but not fully urbanized, are becoming significant consumption pools, attracting the attention of modern retailers (Exhibit 2). These trends will cause the share of middle-class households in Hanoi and Ho Chi Minh City to fall to 31 percent in 2030. (For more on our analysis, see sidebar, “About the research.”)

About the research

The State of Grocery Survey was conducted from the end of 2021 to early 2022 across 15 markets, including Asia, the Americas, and Europe. The sample consists of 1,500 respondents from ages 18 to 75 in each market and spanning all income brackets. The insights on consumer behaviors in this article are derived from the survey outcomes; our analysis focuses on Indonesia and Vietnam.

Consumer demand in ASEAN is underpinned by three themes

As in other regions, the pandemic has had a pronounced—and potentially lasting—impact on consumer behaviors and preferences. Retailers seeking to keep pace should focus on three themes (Exhibit 3).

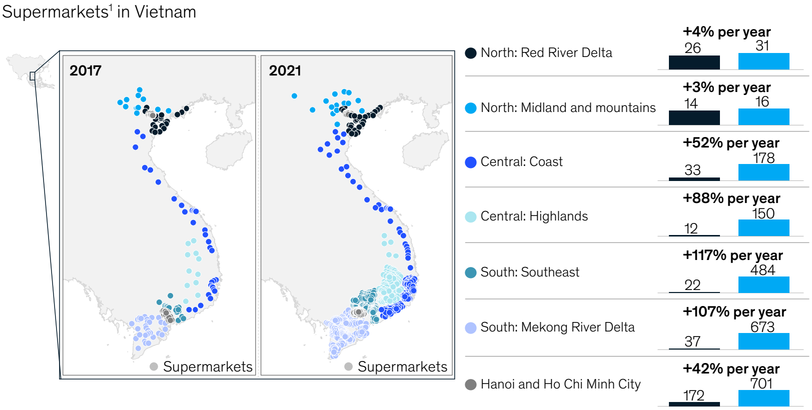
Better value

Amid a period of economic volatility and inflationary prices, consumers are looking for ways to stretch their dollars. For example, they are actively comparing product prices: in Indonesia and Vietnam, around 60 percent of consumers said they would do more in 2022 to save money while shopping. Consumers are also seeking out the best promotions, even if it means making separate purchases across stores and splitting purchases between offline and online channels. Last, shoppers are switching to less-expensive alternatives, such as private-label brands, with Indonesian consumers (44 percent

Exhibit 2

Vietnam’s modern retail has expanded rapidly beyond key cities.

Supermarkets[1] in Vietnam

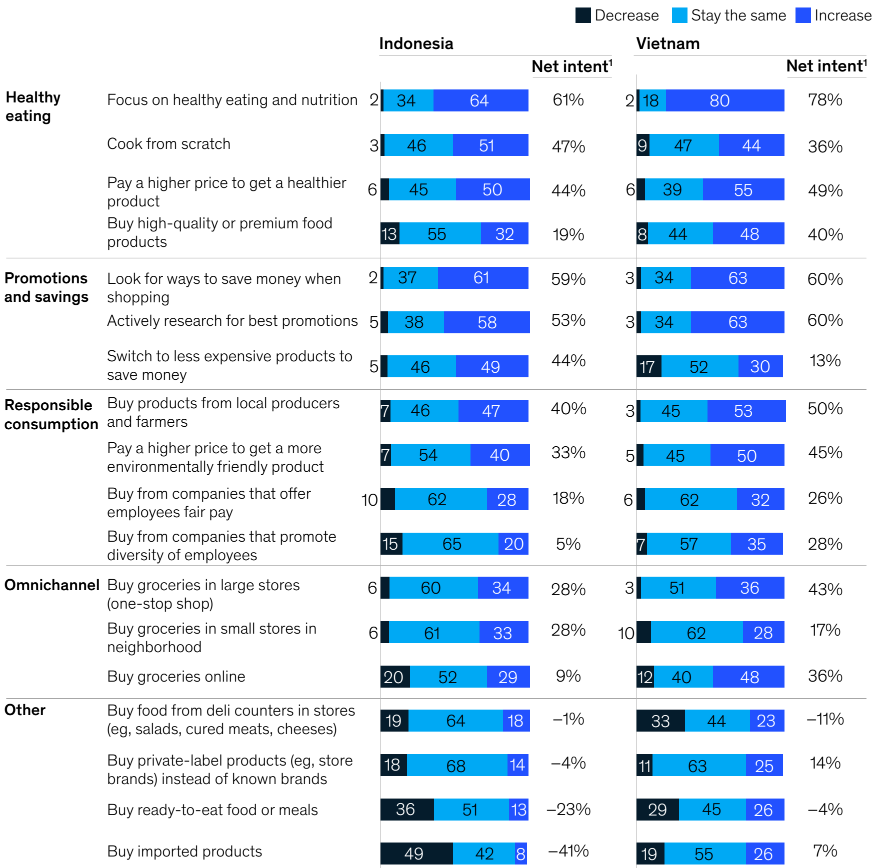


[1]Supermarkets are defined as stores that are more than 150 square meters and are part of chains of more than 10 stores.
Source: McKinsey analysis

Exhibit 3

Healthy eating and value for money will be the defining consumer themes in 2022.

Q: *Think about 2022. Are you planning to do more, less, or about the same of the following?*



Note: Figures may not sum to total, because of rounding.
¹Net intent is calculated by subtracting the percent of respondents stating decrease from the percent of respondents stating increase.
Source: McKinsey State of Grocery Consumer Survey (n = 1,000)

net intent)[2] and Vietnamese consumers (13 percent net intent) leading the charge. This trend was especially prevalent in grocery food items deemed staples (such as rice and cooking spices) and nonfood necessities (for example, bathroom tissue).

Healthier

Another by-product of the pandemic is that consumers have increased their focus on improving their physical wellness. They are devoting greater attention to healthy eating and nutrition, resulting in more balanced diets and reduced consumption of highly processed food products. This shift is demonstrated by the overwhelming net intent among Indonesian and Vietnamese respondents to purchase healthier products (61 percent and 78 percent, respectively).

Despite the overall shift toward maximizing value on essentials, consumers are also spending on high-quality products and paying more to purchase goods that are perceived to be healthier—particularly fresh produce. This behavior is found in mature markets such as Singapore, as well as in developing markets such as Indonesia (44 percent net intent)and Vietnam (49 percent net intent). Rural consumers increased their direct purchases from local farms and producers, thanks to the perception of heightened freshness and quality.

Easier

While ASEAN trails other mature Asian markets, such as South Korea, in online spending, adoption has accelerated during the COVID-19 pandemic. Sixty-five percent of Indonesian consumers and 69 percent of Vietnamese consumers have increased their online purchases with scheduled deliveries during the pandemic. Moreover, they expect to continue buying through online channels in the near future. Similarly, purchases made online with self-collection at stores or other pickup locations also have risen, with around 60 percent of Indonesian and Vietnamese consumers indicating an increase in click-and-collect purchases.

While online purchasing behaviors are likely to persist among urban and suburban consumers in Indonesia and Vietnam, rural consumers are likely to switch back to offline traditional retail as the pandemic stabilizes. This could result from a shortage of suitable delivery slots, as well as from consumers' concerns about overall quality and freshness due to inadequate cold-chain infrastructure in online offerings.

[2] Net intent is calculated by subtracting the percentage of respondents stating they expect to decrease switching to less-expensive alternatives from the percentage of respondents stating they expect to increase this behavior.

While online purchasing behaviors are likely to persist among urban and suburban consumers in Indonesia and Vietnam, rural consumers are likely to switch back to offline traditional retail as the pandemic stabilizes.

In the shopping mindset of ASEAN consumers, three primary factors contribute to the move to online channels:

- *Better prices.* Demand is fueled by e-commerce players that offer deep promotions at high frequency to attract and retain consumers.

- *Personal safety.* During the early stages of the pandemic, consumers made safety a top priority and adapted their behavior accordingly. As ASEAN consumers look to the future, public safety may be a lesser concern, though it is still expected to remain a key driver of online purchasing behavior in parts of the region.

- *Convenience.* Consumers have embraced the option to shop anytime, anywhere and to have their purchases delivered straight to their doorsteps. This proposition is further extended by expectations of fast, free delivery, which is often subsidized by e-commerce players as yet another means of customer acquisition and retention.

Tomorrow's ASEAN consumer: More sophisticated and more discerning

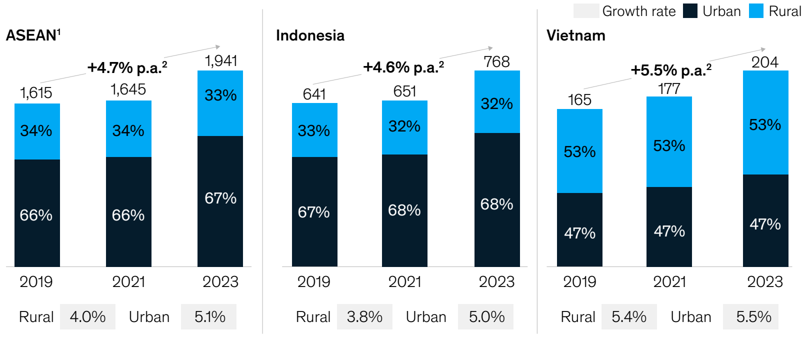
Rising incomes will give ASEAN consumers more discretionary income: through 2023, consumer spending is projected to grow by nearly 5 percent a year across the region (Exhibit 4). In the process, consumers will become increasingly discerning and develop more sophisticated needs.

The following themes, which reflect current consumer preferences in mature global markets, will underpin future trends in ASEAN:

Exhibit 4

Across the Association of Southeast Asian Nations (ASEAN), consumer expenditures are growing by about 5 percent annually, with urban expenditure outpacing rural expenditure.

Total consumer expenditure across level of urbanization, 2019–23, US $, billions



Note: Figures might not sum to total, because of rounding.
[1]Includes Indonesia, Malaysia, Philippines, and Vietnam.
[2]Per annum.
Source: Euromonitor Economies & Consumer Database

- *Heightened awareness for supporting local businesses and communities.* During the pandemic, consumers increased the demand for locally sourced, fresh produce and demonstrated greater awareness and support of local microbrands in packaged food products (for example, locally produced or formulated snacks).

- *Increased attention to environmental sustainability.* Consumers are seeking to buy products that are manufactured or produced in environmentally friendly ways. One indication of this is the increased awareness and acceptance of alternative proteins, which are perceived as better for the environment (though not necessarily healthier). The attention to environmental sustainability also extends to other facets and touchpoints along the consumer shopping journey, such as biodegradable product packaging and sustainably sourced or grown produce.

- *Growing demand for transparency in production, particularly with premium fresh produce.* Consumers are increasingly well informed and knowledgeable; they demand not only validation of label information (for example, a clear indication of the certifying body for label claims) but also heightened transparency in sourcing (such as the country of origin) and in formulation and production (for instance, the composition of ingredients).

The evolving ASEAN consumer base means that retailers must adapt their value propositions. The region remains one of the fastest-growing and most exciting markets in the world for modern grocery retail operators, but the competitive landscape is changing fast.

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ASEAN grocery: Balancing growth with profitability

The race is on to capture market share amid fierce competition. Retailers need to reinvent themselves while retaining a focus on sustainable growth.

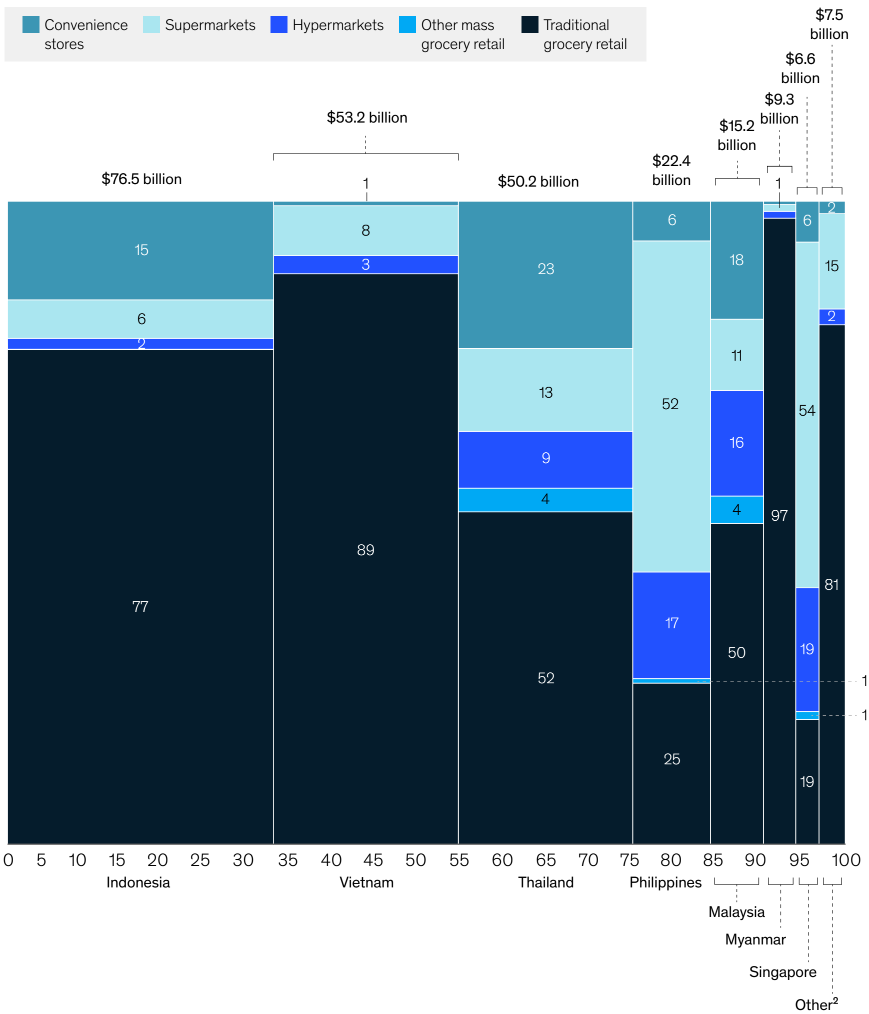
by Matthieu Francois, Clarence Lew, An T. Nguyen, and Hai-Ly Nguyen

The nature of the grocery industry across the Association of Southeast Asian Nations (ASEAN) has evolved significantly. While traditional trade still dominates most markets, ongoing revenue growth of 7 to 10 percent a year is mostly fueled by the rising penetration of relatively newer, modern formats, especially convenience stores and supermarkets (Exhibit 1). It's tantalizing to chase such growth, but pursuing scale without considering the bottom

Exhibit 1

Modern retail formats are driving the growth of the grocery industry in Southeast Asia.

ASEAN[1] market share by store format and country in 2021, %



Note: Figures may not sum to 100%, because of rounding.
[1]Association of Southeast Asian Nations.
[2]Brunei, Cambodia, and Laos.
Source: Euromonitor

line may place retailers at a competitive disadvantage, especially when compared with those who instead balance growth and profitability while retaining the ability to reinvent their business models as they grow.

Two themes guiding growth

The top-line numbers are impressive: revenue growth among grocery retailers is projected to be 10 to 12 percent annually in Indonesia and Malaysia, with Vietnam and Thailand each growing around 7 percent annually in the next decade.[1] The Philippines and Singapore are expected to grow less rapidly because the penetration of modern store formats in those markets is relatively higher.

So what is driving this expansion? Two common themes have emerged across all markets. First, the convergence of formats between traditional and modern trade has resulted in the disproportionate growth of small modern formats. Second, consolidation and localization are prevalent across markets. At this stage, regional (cross-border) expansion has been limited, likely because most strong players have found enough headroom in their own markets.

1. Stronger tailwinds for small modern formats

Across the region, convenience stores and neighborhood supermarkets have become more popular, while family grocers are increasingly locating their stores in residential areas, moving away from the earlier growth model that prioritized dense, high-traffic urban centers. Both chains and independently owned outlets have adopted some of the elements of modern trade.

Yet revenue growth is not homogeneous across formats. Overall, we expect a more rapid expansion of small modern formats, which more effectively meet consumer needs. ASEAN shoppers have lower rates of car ownership than their counterparts in the United States or Europe, as well as less disposable income for large-basket purchases. For both of these reasons, ASEAN shoppers tend to favor stores near their homes that offer a wide and reliable product assortment for daily needs, and they also tend to make more frequent visits for smaller individual purchases. For example, in the past few years, the likes of Bách Hóa Xanh in Vietnam and Alfamart and Indomaret in Indonesia have outpaced market growth. This overall trend within modern trade encompasses two models:

- *On-the-go retailers in dense urban areas.* Convenience stores tend to cater to urban shoppers and rely heavily on high-traffic locations, on-the-go consumption, ready-to-eat food, and a small selection of packaged food and drinks (with more limited fresh-food offerings). In Malaysia, for instance, convenience stores have evolved into three competing concepts: lifestyle retailers, such as FamilyMart and KK Super Mart; minimarts, such as 99 Speedmart; and stores linked to gas stations, such as Shell Select. While we believe more formats will emerge to address other potential consumer needs, all of the above

[1] Euromonitor.

formats have common features: they are typically located in dense urban areas, achieve elevated sales productivity, and can generate relatively high gross margins (which is necessary to cover their significant fixed costs, especially rent and staffing).

- *Core daily needs in residential areas.* Small supermarkets and minimarts have become popular in Southeast Asia, especially in Indonesia and Vietnam. They represent a different value proposition. These stores are typically 150 to 500 square meters in size, catering to most of the core daily needs of households—including fresh food—with product assortments totaling 2,000 to 5,000 SKUs. Companies such as CJ in Thailand and 99 Speedmart in Malaysia, for example, have sought to pivot to this concept when expanding beyond dense urban areas. Compared with convenience stores, small supermarkets and minimarts are scaling faster because they offer a path to growth beyond high-traffic locations in megacities and benefit from lower structural costs, which enables them to achieve profitability. In Indonesia and Vietnam, for instance, industry experts expect small semi-urban minimart formats to be closer to profitability than pure convenience stores.

Interestingly, the industry is starting to see a convergence between traditional and modern retail in which some mom-and-pop stores grow into large family grocers to complement market stalls and other niche outlets. These stores feature a broader product assortment, fixed prices, and a shopping experience closer to that of modern retail, in which people enter the store to shop. Family grocers in rural and suburban areas have the same appeal as a minimart, featuring an acceptable assortment, cashiers, shelves organized by product category, shopping assistance, and transparent pricing. They are also well supported by consumer goods manufacturers and their distributors, receiving a fair share of trade spending, access to consumer promotions, and regular visits by merchandisers.

Corporate retail players have spotted this opportunity and are developing business models to help modernize traditional trade by extending their loyalty programs and distribution networks to family grocers. For example, VinShop-affiliated grocery stores in Vietnam receive sourcing assistance and can offer the VinID loyalty program to shoppers. And the country’s Co.opSmile modern grocery stores by Saigon Co.op are a hybrid format of modern minimarts and traditional grocers.

2. Consolidation and localization within countries but with limited regional expansion

Another distinctive feature in recent years among the markets we analyzed has been industry consolidation. In most markets, we observed strong national champions leading the growth of modern retail by expanding their footprints, adapting their formats, making strategic acquisitions, and localizing offerings to cater to their core shoppers. Some forays by nonlocal players have been observed, such as in convenience stores in Vietnam and the Philippines and hypermarkets in Indonesia, yet the bulk of the market share and growth seems to reside with established local companies.

Several factors have contributed to the success of domestic players in ASEAN countries. First, the regulatory environment may have encouraged foreign players to focus their investments on larger stores. For example, Vietnam requires investors to apply for an "economic needs test" for each individual store opened, while Indonesia and Malaysia have explicit constraints on the ownership of smaller stores. Second, local players have been consistently better at directly addressing local shopper needs, reinventing formats, and rapidly tailoring their assortments. Finally, local insights and on-the-ground decision making have been critical, allowing retailers to identify and capture the best locations. These capabilities are even more important as some local retailers begin to own parallel business units that develop commercial real estate.

Going forward, these national champions may look for cross-border growth opportunities. Some Southeast Asian retailers—such as Central in Vietnam and Alfamart in the Philippines—have already invested across markets. However, companies are likely to continue relying on local strategic partners and acquisitions to enable true cross-country growth. For example, Central in Vietnam partnered with local retailer Lan Chi Mart to expand its footprint in smaller cities, while Alfamart joined forces with SM in the Philippines.

Meanwhile, as core players experience some degree of consolidation, the expectations of the growing local middle class are evolving, leading to more polarization (for example, rising demand for premium fresh products on one end of the spectrum and demand for economically competitive offerings on the other). Paradoxically, this consolidation also leads to more niche opportunities and a fragmentation of the value propositions in the long tail,[2] with the rise of more specialized offerings by premium grocers and category specialists (for example, butcher shops, dairy stores, and cuisine specialists), as well as the possible emergence of discounters.

[2] A strategy in which retailers generate significant profits by selling low volumes of hard-to-find items to many customers.

As core players experience some degree of consolidation, the expectations of the growing local middle class are evolving, leading to more polarization.

Six ways disruption will further shape the industry

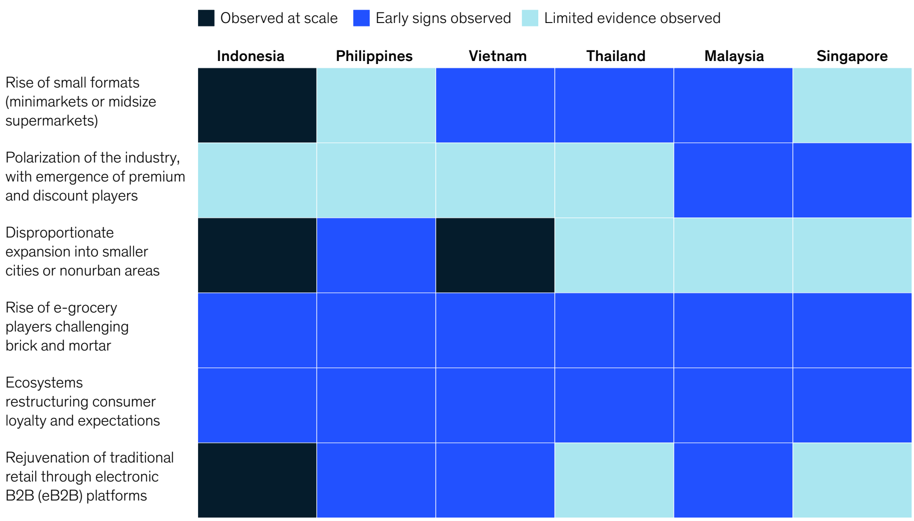
The grocery retail market will continue to evolve considerably in the years ahead in response to changing consumer behavior and preferences, with incumbents seeking to adapt their strategies and new market entrants altering the competitive landscape. We have identified six fundamental trends and disruptions that could help reshape the industry across Southeast Asia (Exhibit 2):

1. *The rise of small formats.* The rise of small formats has consistently fueled growth in local markets, especially in Indonesia and Vietnam. This redistribution of the revenue pool can attract new entrants seeking to capture market share from established retailers. For example, CJ Express in Thailand, 99 Speedmart in Malaysia, and Bách Hóa Xanh in Vietnam are relative newcomers that have built significant momentum.

2. *Polarization.* The growth and diversification of the consuming class in Southeast Asia has resulted in early signs of polarization. Premium retailers such as Jaya Grocer and Village Grocer in Malaysia, Annam Group in Vietnam, and Farmers Market and Ranch Market in Indonesia have enjoyed increased demand. So far, discounters have only made limited inroads given the strong presence of traditional trade among more price-sensitive consumers.

Exhibit 2

Disruption is influencing the shape of the grocery industry across Southeast Asia.



3. *Rural expansion.* The expanding consuming class outside of core urban areas portends faster expansion in rural areas. This demand could give rise to a new competitive set. For example, Vietnamese players Lan Chi Mart and Bách Hóa Xanh built their market share outside of main city centers and helped to redistribute the market's revenue pool. In Indonesia, leading minimart retailers have captured market share in rural areas and tier-two cities.

4. *The growth of e-grocery.* E-grocery retailers have captured a limited share of the market to date, but they could rapidly challenge established players. Retailers' own websites and those of aggregators (for example, GoMart, GrabMart, Pandamart, and Shopee Supermarket), as well as social commerce, are on the rise. Social commerce can take many forms, including platforms specializing in group buying, social-media networks integrating sales mechanisms, and smaller sellers communicating directly with customers via chat features. Many retailers are also using dark stores[3] to accelerate delivery speed and support the rise of quick commerce (delivery within a couple of hours or even minutes).

5. *Consumer behavior strategies.* Loyalty and ecosystem strategies have emerged as a powerful force in some markets and are reshaping consumer behavior. While retailers continue to own their consumer databases and innovate to develop stickier relationships, consumer goods companies are also participating in retail to build their ecosystem. Direct-to-consumer strategies (both online and offline) have emerged as a clear trend. For example, TH Group and Vinamilk are experimenting with physical retail in Vietnam.

6. *Electronic B2B (eB2B) platforms.* Several Southeast Asian markets are witnessing the rise of eB2B platforms,[4] which help shore up the competitiveness of mom-and-pop stores. This evolution, particularly prevalent in countries such as Indonesia, can slow the rise of modern trade, especially in rural areas.

Charting a path to profitability

The dynamism of the grocery industry is only half the story. Retailers also need to focus on costs, margins, and operating models (Exhibit 3).

From 2010 to 2019, most ASEAN retailers focused on grabbing a share of the market and riding the tailwinds of modern trade growth. For all the momentum in ASEAN grocery, however, profitability has proved elusive and inconsistent across formats (Exhibit 4). Indeed, while championing

[3] Brick-and-mortar locations that serve as distribution outlets and are not open to visitors.
[4] "Digital disruption: The rise of eB2B in fragmented retail," McKinsey, January 14, 2022.

Exhibit 3

A grocery store's profit-and-loss ratio varies by concept and market, driven largely by labor, logistics, and rent costs.

	Operating profit breakdown, % sales	**Key drivers**	**Post-COVID-19 pressure**
Sales	100		
Cost of goods sold	65–90	Cost of inventory and materials Influenced by contract with suppliers (usually better with scale)	Inflation and supply chain disruption
Gross margin	10–35	Private-label products usually enjoy higher gross margin; a higher mix of private-label products vs a supplier-driven portfolio is better for retailers	Inflation and supply chain disruption
Operating expenditures	10–30	The biggest components: store personnel, logistics, rent, and utilities; other costs: marketing, IT, and overhead Driven by operational efficiency and the expansion plan	Inflation and supply chain disruption
Operating margin	−5–10		

different formats has accelerated the growth of retailers jockeying for position in the marketplace, they still find it difficult to turn a profit. A case in point: many hypermarkets in Indonesia and some convenience-store chains in Malaysia and Vietnam still do not break even.

Recent macroeconomic developments, such as rising inflation and frequent supply chain disruptions, are putting additional pressure on formats that have yet to reach scale in specific countries, such as convenience stores in Vietnam. Among grocery retailers, the traditional single-minded pursuit of growth and scale shows signs of shifting, with some retailers bucking this trend. For example, Co.op Mart in Vietnam, AEON in Malaysia, and Puregold in the Philippines have managed to sustain annual operating profits over time. Their success is due in part to their long-standing operation in the market, which enables them to focus on controlling costs, determining a suitable profitability equation, and negotiating with suppliers from a position of strength.

Emphasizing operational excellence

We expect retailers to take further action to achieve profitability through a greater focus on operational excellence, in which the store network is a large component. Our analysis indicates that two areas have the potential to capture net cost savings totaling around 8 to 12 percent of revenue. First, assessing end-to-end

Exhibit 4

Market momentum is inconsistent across store formats.

Market size 2020, $ billions – **Market growth,** 2016–20 CAGR
Profitability – **Consolidation,** % share of top 3

< 0% | 0–2% | > 2%

Format	Country	Market size 2020, $ billions	Market growth, 2016–20 CAGR	Profitability	Consolidation, % share of top 3
Hypermarket	Malaysia	3.2	–2.0	~4.0	~74%
Hypermarket	Vietnam	1.3	3.0	~0	~90%
Hypermarket	Indonesia	2.0	–5.0	< 0	~85%
Hypermarket	Philippines	3.8	6.0	3.0–7.0	~86%
Hypermarket	Thailand	6.5	–2.0	~4.0	~100%
Hypermarket	Singapore	0.9	0	3.0–6.0	~100%
Supermarket and O2O[1]	Malaysia	2.1	0[2]	> 4.0	~28%
Supermarket and O2O[1]	Vietnam	3.2[3]	9.0	–3.0 to 5.0	~90%[4]
Supermarket and O2O[1]	Indonesia	5.2	0	–3.0 to 10.0	~14%
Supermarket and O2O[1]	Philippines	11.5[4]	4.0	2.0–5.0	~40%
Supermarket and O2O[1]	Thailand	6.4	5.0	> 4.0	~23%
Supermarket and O2O[1]	Singapore	3.3	7.0	4.0–10.0	~73%
Convenience store or smaller format	Malaysia	2.0	9.0	–1.0 to –5.0	~85%
Convenience store or smaller format	Vietnam	0.4	18.0	< –5.0	~74%
Convenience store or smaller format	Indonesia	12.5	6.0	~2.0	~96%
Convenience store or smaller format	Philippines	1.4	9.0	Up to 6	~93%
Convenience store or smaller format	Thailand	10.7	3.0	~5.0	~91%
Convenience store or smaller format	Singapore	0.4	–1.0	> 6.0	~99%

[1]Offline to online.
[2]Growth still exists in certain segments, such as premium supermarkets.
[3]Subscale market.
[4]The definition of supermarkets can fluctuate over countries. For example, Vietnam's definition includes Bách Hóa Xanh (BHX) and Vinmart+ (small formats that could be considered minimarts). Conversely, the supermarkets in the Philippines include relatively large formats.
Source: Euromonitor (retail sales value, including tax and year-over-year exchange rate), 2021

store operations can eliminate non-value-added work, automate labor-intensive tasks, and optimize the operating model—even in markets where the cost of labor is relatively low. Second, retailers can rationalize their store network and reduce overall real-estate costs while identifying underpenetrated areas in which to build or buy stores. For example, between 2017 and 2019, Vietnam's VinCommerce opened nearly 1,000 outlets annually, including both its supermarket and minimart formats. However, after Masan acquired the company in 2019, 750 outlets were closed, and VinCommerce's supply chain was revamped to break even by fourth quarter 2020.

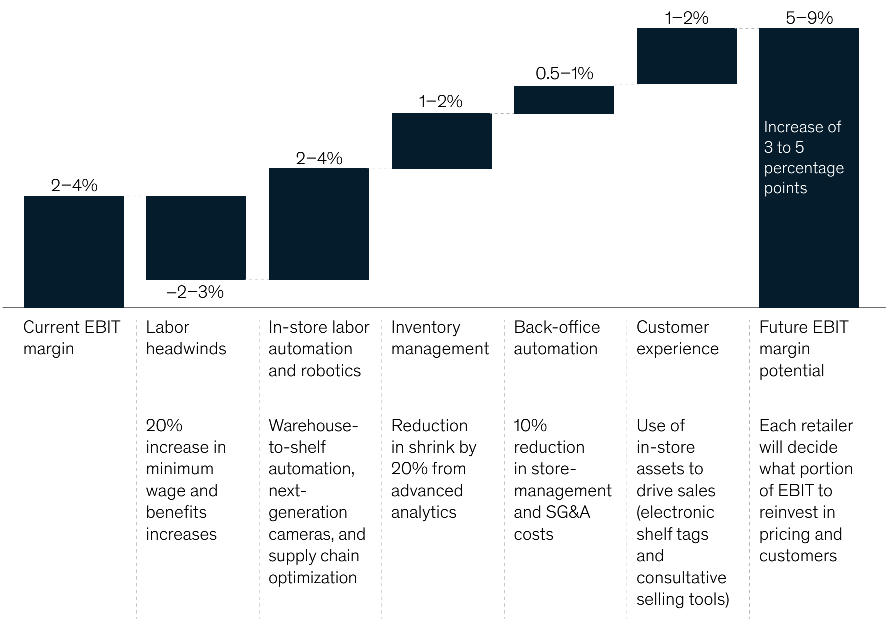
In addition, retailers should actively review commercial terms with suppliers to design a profitable portfolio, including finding a balance for the space of their own brand in each category. Retailers have become more willing to aggressively push suppliers to offer larger discounts (including in the back margin) and move to new vendors if their prices aren't met. In addition, they have been more proactive in putting together teams of category leaders to make tough decisions on specifications, demand, and costs to drive this effort. Increasingly, leading retailers are paying even more attention to structural costs such as rent, indirect procurement, and payroll. Retailers can form creative partnerships to address these areas. For example, Alfamart collaborated with Pertamina to develop Bright Store, a minimart concept in gas stations that makes use of Pertamina's existing real estate.

Across operational-excellence levers, digital transformation is critical to achieve profitability. Retailers need to consider how they can harness emerging technologies and rich, granular customer data to transform the in-store customer experience and the efficiency of store employees.

Making progress on the digital journey can have a pronounced impact. Stores that are already profitable could double EBIT margins, with the added benefits of improved customer experience, better employee engagement, and an easier-to-run store (Exhibit 5). For stores that have yet to break even, the strategic use of technology and a thorough diagnostic can speed the journey to profitability.

Exhibit 5

Properly implemented technology can double store profitability in grocery.



Source: *Future of retail operations: Winning in a digital era*, McKinsey, January 2020

To achieve growth and profitability simultaneously, retailers must take a wide range of variables into account, including market dynamics, the competitive landscape, and format types. Continued disruptions will make the task even more difficult. Yet by maintaining a laser focus on changing customer preferences in different markets and promoting operational excellence, retailers can make progress on both fronts.

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Crafting an omnichannel value proposition for the e-grocery revolution

Shifting consumer attitudes have accelerated the trial and adoption of e-grocery, with implications for omnichannel strategy.

by Dymfke Kuijpers, Ali Potia, and Opal Wu

Before the pandemic, grocery was often described as the last frontier of e-commerce. The dramatic acceleration of growth and consumer acceptance of online channels over the past two years has changed the equation.

The growth of e-commerce is being spurred by convenience (“anywhere, anytime”), safety (“direct to my doorstep”), and promotions (“better deals, lower prices”). Safety was an especially important concern during the pandemic, with a combination of movement restrictions and consumers’ reluctance to be exposed to crowded spaces forcing retailers to experiment with and adopt e-grocery.

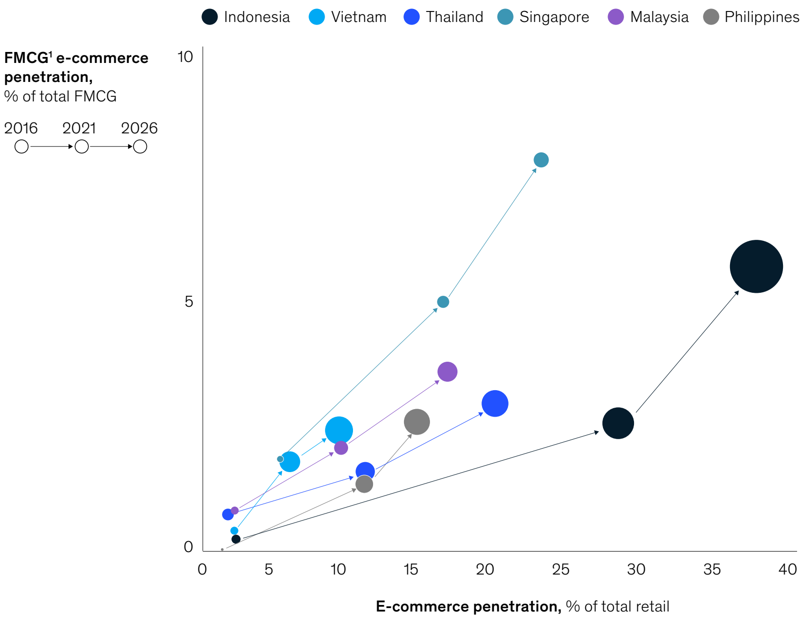
In Indonesia, for example, consumers have demonstrated a growing preference for online shopping: approximately 60 percent of urban and suburban respondents to a recent McKinsey survey[1] indicated they shop online more now than they did before the pandemic. This behavior is expected to persist over the next 12 months. The same trend is playing out in Vietnam, with consumers expecting to continue their pandemic-induced migration to online channels.

As a result, e-grocery penetration in the Association of Southeast Asian Nations (ASEAN), while still low compared with more mature markets such as China and

[1] For survey details, see “The state of grocery in Southeast Asia” on page 6.

Exhibit 1

Online grocery and e-commerce penetration in Southeast Asia will continue to rise.



Note: Online grocery defined as the total of the following e-commerce subcategories: beauty and personal care, consumer health, food and drink, home care, and pet care. The size of the circles is representative of total market size for online groceries.
[1]Fast-moving consumer goods.
Source: Euromonitor

South Korea, is continuing to grow rapidly and is expected to rise from 1–2 percent in 2021 to 3–5 percent by 2026 (Exhibit 1). The total market size of e-grocery across Southeast Asian markets is expected to reach nearly $17 billion by 2026, with a projected compound annual growth rate of 16 percent from 2022 to 2026 (Exhibit 2).

Half of this increase could come from Indonesia, where the market is expected to grow faster than other Southeast Asian markets. Nevertheless, other countries are forecast to at least double their e-grocery markets from 2021 to 2026.

Competition is intensifying from multiple angles

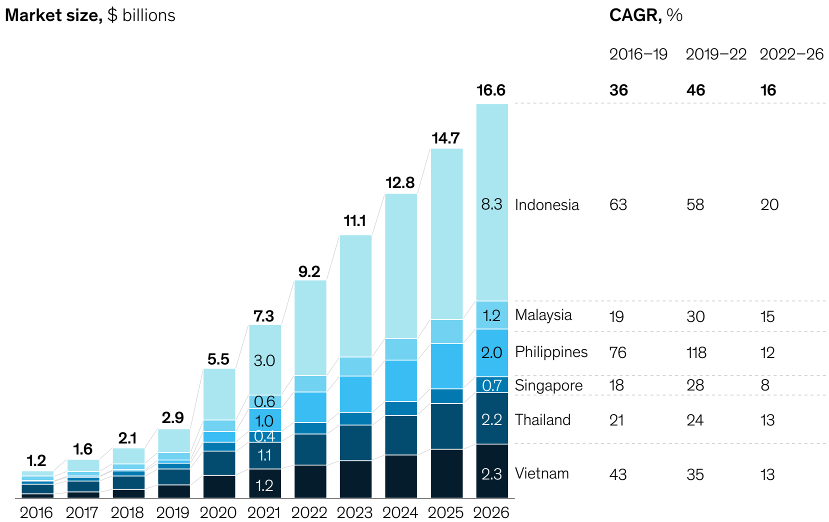
Along with this rapid growth and changing consumer behavior, we have seen a flurry of activity from online grocery–focused start-ups, platforms, ecosystem players, and incumbent brick-and-mortar retailers.

Online grocery–focused start-ups

Renewed tailwinds behind this sector have attracted venture capitalist (VC) interest, resulting in a 7.3 times increase in funds raised by online grocery–focused start-ups, from $26 million in 2020 to $190 million in 2021 (Exhibit 3). Most deals have so far focused on Indonesia, with multiple

Exhibit 2

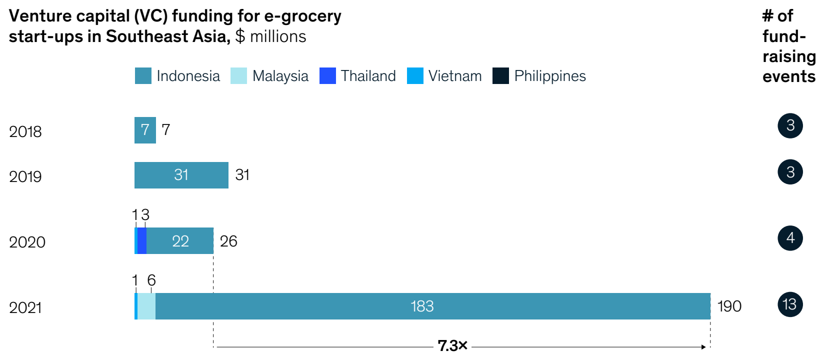
The online grocery market in Southeast Asia is expected to grow through 2026.



Note: Figures may not sum, because of rounding. Online grocery is defined as the total of the following e-commerce subcategories: beauty and personal care, consumer health, food and drink, home care, and pet care.
Source: Euromonitor

Exhibit 3

The amount of venture capital funding for e-grocery start-ups in Southeast Asia grew more than sevenfold between 2020 and 2021.



Source: PitchBook

new business models emerging beyond more traditional pick-from-store or dark-store models:

- The quick-commerce model features an assortment of 1,000 to 2,000 SKUs delivered from microwarehouses to consumers within 15 to 20 minutes. This business model, which includes companies such as Astro, Bananas, and Dropezy, has proliferated since 2021.
- The farm-to-table model involves sourcing produce directly from farmers and other primary producers and selling to either businesses or end consumers. This model bypasses intermediaries such as wholesalers and distributors. Start-ups have raised significant funds; for example, Sayurbox raised $120 million in series C funding, TaniHub $65.5 million in series B funding, and Segari $16 million in series A funding.
- The grocery-focused social-commerce model consists of companies that deliver group orders aggregated by community leaders to rural areas. Leading players have emerged in Indonesia (for example, Dagangan), Vietnam (Mio), and the Philippines (SariSuki).

Ecosystem players

Ecosystem players have moved into grocery, seeking more frequent purchases to organically increase revisits and capture a greater share of wallets (and stomachs). Super apps (such as Gojek and Grab), e-commerce marketplaces (for example, Shopee, Tokopedia's Tokomart, and Blibli's Bliblimart), and even food delivery apps (Foodpanda) have waded into this segment with various offerings. These services include pick and fulfill from store (whether third-party locations or a retailer's own stores), fulfill from the retailer's warehouse, click and collect, and marketplace models.

However, in response to increased competition, some players have sought to accelerate their efforts by pursuing bolder inorganic moves with incumbent brick-and-mortar grocers, including taking majority stakes (for example, Grab's $400 million stake in Jaya Grocer), minority stakes (such as GoTo's 4.76 percent share of Matahari Putra Prima), or forming joint ventures (for example, Bukalapak and CT launched AlloFresh, an online-grocery platform). Ostensibly, these deals enable players to quickly acquire a loyal customer base, reliable supplier pool, traditional retail capabilities, and consumer insights. Combining offline and online operations can also boost efficiency (popularized by Alibaba's "New Retail" model). However, whether this value can be fully captured will depend on the extent to which these businesses with different pedigrees, mindsets, and operating models can be successfully integrated.

Incumbent brick-and-mortar grocers
Incumbent brick-and-mortar grocers have responded to these moves by upgrading their e-grocery offerings in a more concerted way, a break from the "wait and see" attitude prevalent before the pandemic. For example, Hypermart has developed an e-grocery portal and a mobile app, Hypermart Online, to provide both a grocery delivery and click-and-collect service. And supermarket chains such as LotteMart and Super Indo have created their own shopping apps.

While it's too soon to determine which companies will come out on top, consumers will be the biggest winners for the next few years. They stand to benefit in several ways, including through better prices, fueled by an increase in promotions and incentives as multiple players fight to acquire and retain the same group of consumers; greater convenience, as more players enter the e-grocery market and try to differentiate on service levels, particularly speed of delivery; and improved quality and freshness, as direct-to-consumer models emerge to connect farmers and other primary producers with end consumers, disintermediating distributors and retailers in the value chain.

Challenges await e-grocery players

Despite this influx of attention and capital, e-grocery has been and will likely remain a challenging segment to crack. Already in recent months, the relaxation of movement restrictions and a tightened external fundraising environment have dampened some of the enthusiasm surrounding this sector. The shift from offline to online is starting to revert to the longer-term mean, and competitive intensity has lessened. A greater focus on profitability pervades and reinforces the challenges the sector faces.

Matching or exceeding the quality of the offline experience
Southeast Asia faces some challenges that are unique to the region:

Out-of-stock and replacement process when picking from store. Most grocery retailers are still using legacy IT systems for point-of-sale and stock management, so they lack an integrated inventory management system between their physical stores and e-grocery platforms. The resulting stockouts can frustrate consumers. Smart replacement systems (based on harnessing data and analytics or obtaining consumer preferences through an app or call centers) can help to reduce the negative impact, but some disappointment is unavoidable. Retailers that opt for fulfillment from their own dark stores or microwarehouses will have an advantage because they can provide real-time stock visibility to the consumer.

Fresh produce according to the consumer's preferences. Target consumers for e-grocery are generally from middle- to higher-income levels, whereas the frontline workforce that is picking for fulfillment may not be as familiar with different types of fresh produce. One example is picking avocados with the right degree of ripeness: some consumers want them fully ripe for immediate consumption, whereas others might want to keep them for future consumption. Retailers that can provide relevant options for consumers to choose from and have intelligent workflows embedded in their picker apps will gain an advantage.

Preserving cold-chain integrity. The prevailing method of fulfillment in Southeast Asia is by motorbike, which can navigate traffic more easily and minimize capital expenditures. However, this delivery mode could have a potentially negative impact on consumer perception of the quality of chilled or frozen produce. Retailers that can innovate on the design of delivery boxes, which are typically strapped to the back of a motorbike, and institute strict procedures on the handling and packaging of such items will be better positioned to win the trust of skeptical consumers.

Achieving unit economic profitability

Margins in offline grocery are already notoriously thin. Making the unit economics work in e-grocery requires a delicate balancing act. While next-day delivery can be and is generally profitable, making the equation work for same-day and especially within-an-hour delivery is particularly challenging.

The primary tension is between average order sizes and fulfillment costs, both of which depend on each player's chosen business model and value proposition

Factors such as pricing and promotions, minimum order value and fees, the degree of seamlessness, and personalization in the customer experience all have a role to play in driving up average order sizes.

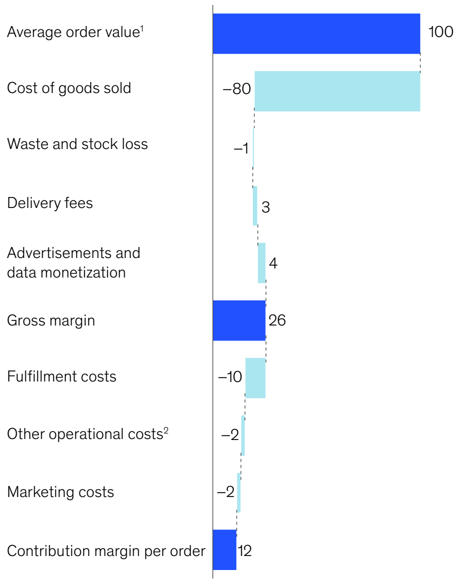
(Exhibit 4). For example, quick-commerce players can offer only a limited number of SKUs to meet their promises on speed. The result is smaller average order sizes, which can be partially offset by efficient picking in optimized microwarehouses and lower last-mile delivery costs due to density of orders in a tight radius. On the flip side, an incumbent's online offering will generally include a full range of SKUs (the same as in-store), allowing customers an opportunity to construct a full shopping basket. Yet fulfillment costs are often hampered by inefficient picking from their stores or large distribution centers and delivery, which is sometimes by truck from locations far away from customer hot spots.

Factors such as pricing and promotions, minimum order value and fees, the degree of seamlessness, and personalization in the customer experience all have a role to play in driving up average order sizes. For fulfillment costs, operational excellence and density of demand are key drivers as well.

Exhibit 4

E-grocery players must optimize operations and seek alternative revenue streams to achieve profitability.

Unit economics structure



Key value drivers, % of average order value

Average order value: key variable to cover fixed costs per delivery; correlated with assortment (number of SKUs on offer) but can also be influenced through pricing and promotions, minimum order value and fees, and enhanced user experience and personalization

Delivery fees, < 5%: in Southeast Asia, there is a general reluctance among consumers to pay more than 5% of the order value for delivery

Advertisements and data monetization, > 3–5%: high-margin source of additional revenue from selling advertising and other promotional solutions (typically to FMCG[3] brands) and monetizing data and insights on consumers

Fulfillment costs, 8–15%: major cost item with high variance depending on level of operational excellence (eg, processes and systems, driver scheduling and dispatch, route optimization, automation) and increasing density of demand

Marketing costs, 1–2%: does not refer to the initial cost of customer acquisition but rather to additional ongoing promotions (eg, discount vouchers, free-delivery offers) or other incentives given to existing customers to drive repeat purchases

[1]Excluding value-added tax.
[2]Includes payment processing fees, contact center, replenishment, inbound supply chain, and consumables.
[3]Fast-moving consumer goods.
Source: McKinsey analysis

Advertising is a revenue stream that holds a lot of promise. Players in Asia are making strides, with some well on their way to achieving 4 percent of gross merchandise value (GMV) through advertising. By comparison, the international benchmark lies above 10 percent.

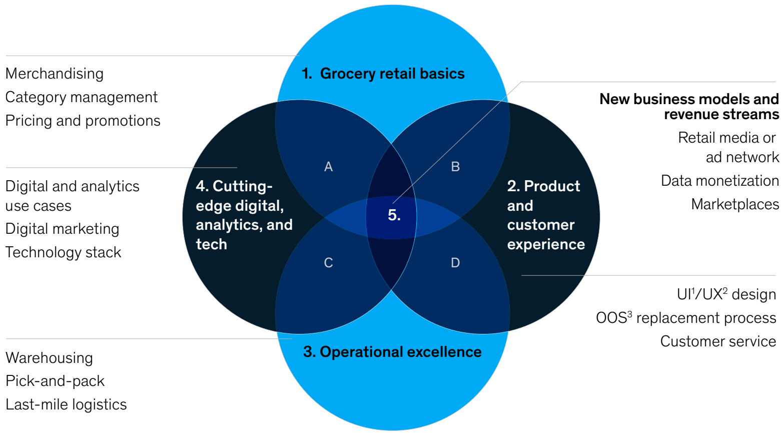
Implications for industry participants
Now more than ever, only players that can excel across five key areas (Exhibit 5) by combining both old and new capabilities will emerge as winners in e-grocery.

1. Mastery of grocery retail basics. Incumbent grocers have a clear advantage in merchandising, category management, and pricing and promotions; these capabilities are core to running a profitable grocery retail business. However, in e-grocery, incumbents have room to further develop these capabilities through the application of advanced analytics and technology to specific use cases and tailor them to an online-shopping experience.

2. Product and customer experience. Creating an inviting online grocery–shopping experience is not an easy feat given the breadth of SKUs. To be competitive, retailers must offer an easy browsing and searching experience across those SKUs, provide high-quality images and product descriptions, and

Exhibit 5

Achieving profitability in e-grocery requires marrying traditional and new capabilities.



Secondary intersections:
A. Advanced-analytics use cases
B. Translating offline shopping experience to online
C. Order and delivery optimization and automation
D. Customer needs and operations synchronization

[1]User interface.
[2]User experience.
[3]Out-of-stock.

manage inventory and pricing, which can be highly dynamic throughout the day. The list goes on. Incumbents have often suffered from poor execution (for example, products without images or any descriptions), rudimentary front- and back-end functionality, and a lack of integration with their offline retail systems. At the same time, newer players have often tried to approach the grocery category with a generic e-commerce lens, trying to replicate for grocery what has worked well for categories such as electronics or household goods.

Retailers should adopt a consumer-backed, grocery-specific approach to ensure a fit-for-purpose and seamless customer experience. This effort is especially critical given the high propensity of first-time e-grocery shoppers to revert to offline shopping after a poor initial experience with online shopping.

3. Operational excellence in warehousing, picking and packing, and last-mile logistics. While incumbents are familiar with bulk logistics, bulk breaking, and store replenishment, picking and packing for smaller online orders and last-mile logistics are typically new capabilities that need to be built. Even for newer players, achieving operational excellence, especially in coordinating and routing drivers, is a challenging yet critical element to ensure positive unit economics. Automation will be a critical component: while business cases have traditionally been negative, rising labor shortages and the falling costs of automation can help to tip the scales.

4. Cutting-edge digital, analytics, and technology. Grocery-focused start-ups and ecosystem players will have a head start on digital and analytics, thanks to their tech-first pedigree and access to talent. Incumbents are quickly catching up, however, and are investing heavily in building their own capabilities and transforming legacy technology infrastructure.

5. New business models and revenue streams. Grocery retailers that can master the preceding capabilities have the potential to augment their core business

Retailers should adopt a consumer-backed, grocery-specific approach to ensure a fit-for-purpose and seamless customer experience.

with new business models and revenue streams. Opportunities include generating advertising revenues through a retail media network, monetizing insights from the rich data collected at the point of sale, and collecting fees from third-party vendors that list their products on a marketplace. The real bottleneck here is not technology or analytics but rather go-to-market capabilities—for example, consumer and market research, sales, partnerships and business development, and marketing—that are often underdeveloped in mature, traditionally stable sectors such as grocery retail.

E-grocery is the fastest-growing channel in many countries and is a magnet for investment and competition. Its growth is also forcing retailers to reimagine their omnichannel offerings. Despite several challenges, including achieving favorable unit economics, retailers that focus on five key areas can build the capabilities needed to win in the years ahead.

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How grocers could use sustainability to transform Asian food systems

Grocers need to develop sustainability transition plans and think more broadly about the role they can play in encouraging change across the full value chain.

by Matthieu Francois, Bartosz Jesse, Veena Lertkriangkraisorn, and Sofia Moulvad Veranen

Increasingly severe global weather events and the urgent tone of the 2021 United Nations Climate Change Conference (COP26) have made it crystal clear: now is the time to truly prioritize sustainability. Asia is particularly exposed in this regard because Asian consumers are becoming more environmentally conscious (Exhibit 1).[1] While climate may be top of mind, it can no longer be separated from other concerns about how we live and make supporting economies more sustainable. To address these problems, it is crucial to consider the food system, which accounts for 34 percent of global greenhouse-gas (GHG) emissions.

It's not simple to reform a system that more than 500 million farmers, workers, and employees around the world depend on, and that plays a critical role in people's health. Yet the pressure on retailers is increasing (particularly in Asia) as consumers demand sustainable products and services, investors shift to sustainable investments, and regulators implement new and tighter sustainability regulations.

Grocers are in a unique position to be a driving force in this much-needed sustainability transformation. They're ubiquitous, they're integral to local and national economies, and they have the power to both influence consumer choices and collaborate with farmers, suppliers, and even other grocers. And, finally, they can benefit from the transition because sustainability can go hand in hand with value creation. In fact, our analyses show that while sustainability presents potential risks, it also offers opportunities for grocers' top lines, margins, and costs—adding up to around 50 percent of EBITDA.

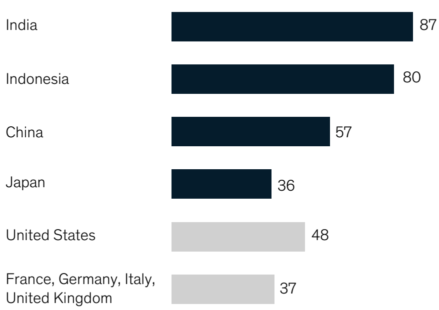
[1] Rajat Gupta and Jonathan Woetzel, "Asia's net-zero transition: Opportunity and risk amid climate action," McKinsey, April 29, 2022.

Exhibit 1

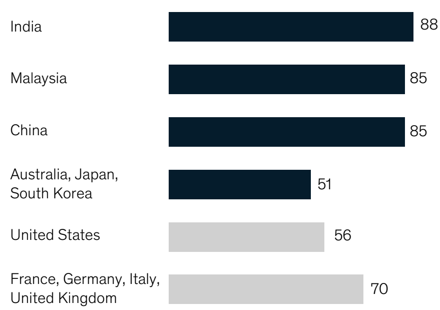
Asian consumers are increasingly eco-conscious.

Survey results

More concerned about sustainability
Q: *How do you currently perceive the importance of packaging sustainability compared to the time before COVID-19?*[1]
% of consumers who are more concerned



Changing behaviors
Q: *Over the past few years, have you made any changes regarding the products and services you buy or use, specifically out of concern about climate change?*[2]
% of consumers who made changes



Note: Countries for each grouping selected based on data availability. Averages for multiple countries are not weighted by population.
[1]McKinsey Packaging Survey, 2020.
[2]Ipsos survey of 19,964 online adults aged 16–74 in 28 countries, conducted October–November 2019.
Source: Ipsos; McKinsey Packaging Survey; McKinsey Global Institute analysis

Making sustainability a strategic imperative

Some food retailers have already kick-started their sustainability efforts with portfolios of initiatives that typically span decarbonization, packaging, assortment, and social sustainability. For example, Thailand's Tops Supermarket optimizes its fuel usage and supports local producers by making its backhaul trucks available to transport goods purchased from farmers. Singapore's UglyFood sells excess or ugly produce and sustainably sourced goods. Australia's Scoop Wholefoods sells products carefully selected for their environmental and health benefits, as well as for their minimal packaging; it also uses 100 percent green energy in its operations. Yet Asian grocers are often simultaneously juggling other critical strategic transitions, such as digitalization or expansion into countries whose competitive landscape is still predominantly fragmented. In addition, grocers associate sustainability with significant costs and have not solved the challenge of creating value through "commercialization" of green activities, which has slowed progress.

We believe grocers need to make sustainability an integral part of their businesses with a strategic perspective based on value creation and tailored to their circumstances. We have identified three things retailers need to start doing differently:

1. reframe their purpose, typically around five themes that matter
2. explore a set of business actions that drive sustainability while creating tangible value (higher margin, accelerated growth, and reduced risks)
3. adjust their operating model in a way that will make sustainability actions core to the business rather than an afterthought

1. Properly framing the sustainability ambition around the five themes that matter

Viewing the food system's sustainability from an environmental, social, and governance (ESG) perspective is a good start, but grocers can go further. A broader strategy would include five explicit dimensions: health, the environment, the economy, animal welfare, and livelihoods (HE^{2}AL). Within this framework, 15 topics should matter most to grocers (Exhibit 2).

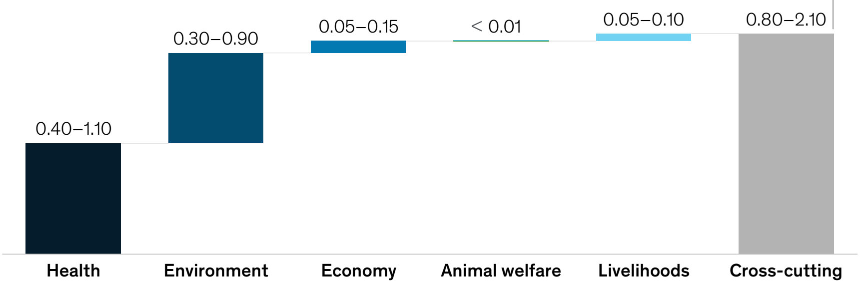
Viewing the food system's sustainability from an environmental, social, and governance (ESG) perspective is a good start, but grocers can go further.

Exhibit 2

Grocers can help mitigate the external costs to society from food through 15 sustainability levers.

Cost to society per $ spent on food, $

For every dollar spent on food, there is an estimated **$0.80–2.10 in external costs**



Sustainability levers for retailers

Health

1 Enable healthy lives through healthier assortment (incl private labels)

2 Ensure food safety

Economy

8 Secure food access and affordability

9 Increase supply chain resilience

Livelihoods

11 Protect human rights

12 Ensure fair pay

Environment

3 Decarbonize own operations and value chain

4 Achieve plastic waste and packaging circularity

5 Eliminate or reduce food waste

6 Reduce biodiversity impact, incl deforestation

7 Increase resource efficiency (eg, water)

Animal welfare

10 Strengthen animal welfare

Cross-cutting

13 Create product transparency and traceability

14 Champion standards, certifications, and sustainable policies

15 Market sustainability activities

Source: Food and Land Use Coalition; Perotti; Rockefeller Foundation; Sustainable Food Trust

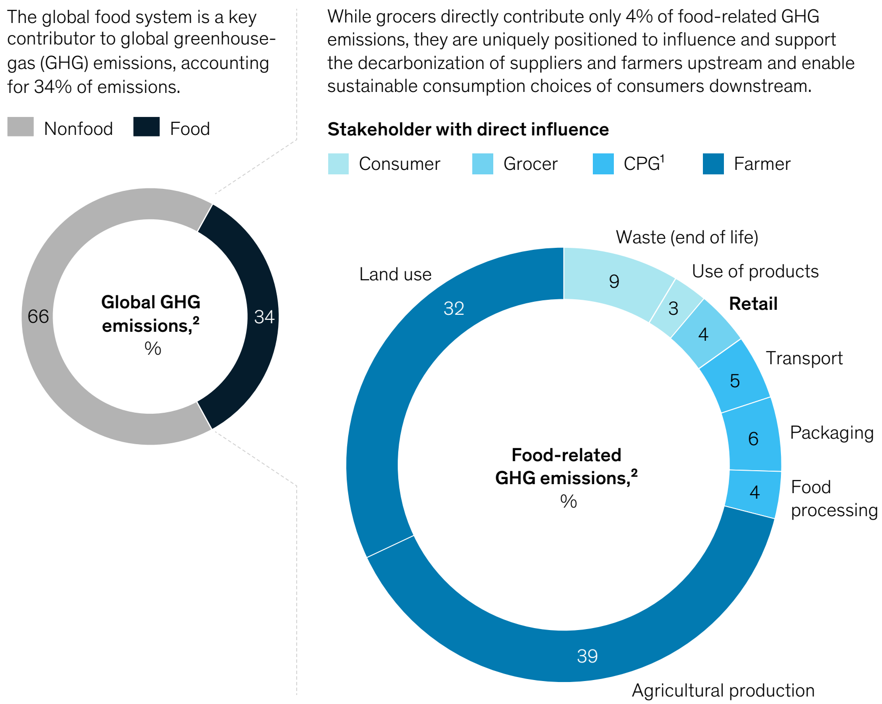
Retailers should focus on all HE^2AL dimensions and look at the full value chain to maximize value creation and sustainability impact. Looking at the full value chain is important because many value creation opportunities and much of the sustainability impact come from interactions with suppliers and customers.

Let's take decarbonization as an example. While the food system accounts for more than a third of global GHG emissions, only about 4 percent of grocers' direct contribution is from grocers' own operations (Scope 1 emissions) and from purchased electricity and heat (Scope 2 emissions). Most emissions are generated along the value chain (Scope 3 emissions), with about 80 percent stemming from land use, agricultural production, food processing, and packaging (Exhibit 3).

This means grocers need to focus on two elements. First and foremost, they should work on their carbon footprints and optimize their own operations. This can

Exhibit 3

Food systems account for more than a third of global greenhouse-gas emissions.



Note: Global top-down perspective; figures may not sum to 100%, because of rounding.
[1]Consumer packaged goods.
[2]CO_2 equivalent.
Source: Crippa et al., "Food systems are responsible for a third of global anthropogenic GHG emissions," *Nature Food*, March 8, 2021, Volume 2

include making stores energy efficient, sourcing green energy, and reshaping cooling technologies and logistics.

Second, grocers should take a holistic view of GHG emissions created along the entire value chain, reviewing how their assortment and sourcing choices and policies contribute to them. Reducing Scope 3 emissions while creating value can include actions such as introducing transparency requirements for all products, changing product assortment (for example, introducing lower-emissions alternatives), adjusting specifications (such as specifications on shape or size that can cause farmers to waste "nonfitting" produce), supporting farmers who want to develop emissions-reducing agricultural production processes, or improving supply chain financing based on the GHG footprint of the supplier. For example, dairy giant Arla has developed a program to incentivize farmers to use greener agricultural practices, allocating up to 4 eurocents per kilogram of milk to it (equal to about €500 million annually at their current volumes or 7 percent of the value of the milk at current prices). The company's point-based system builds on the "climate check" already in place for approximately 8,000 farmers in Europe, who report their practices by answering a 200-question survey regularly. Arla compensates farmers for their practices, such as feed that cuts methane emissions and precision farming techniques, with the goal of becoming CO_2-neutral by 2050.[2] Tackling Scope 3 emissions can be quite complex because grocers need to collaborate with their partners along the value chain, but such examples show that incentive schemes are becoming a reality.

Along the five HE²AL dimensions, grocers should make conscious choices about where they want to lead, where they want to benefit from resource productivity gains, and where they simply want to comply with regulations. This prioritization typically considers the company's starting point as well as

[2] Irina Anghel, "Dairy giant Arla wants to pay farmers more for low-emission milk," Bloomberg, April 19, 2022.

Grocers should make conscious choices about where they want to lead, where they want to benefit from resource productivity gains, and where they simply want to comply with regulations.

those of competitors, expectations from stakeholders, and, importantly, the potential for value creation in the form of EBITDA upside or risk mitigation.

These opportunities then need to be translated into concrete targets that can be communicated internally and externally.

2. Creating value from the sustainability transformation

Grocers can generate significant value from a well-positioned sustainability transformation. The value generated can come from six types of value creation levers, which can be further grouped into reducing downside risks and seizing the opportunities sustainability offers (Exhibit 4).

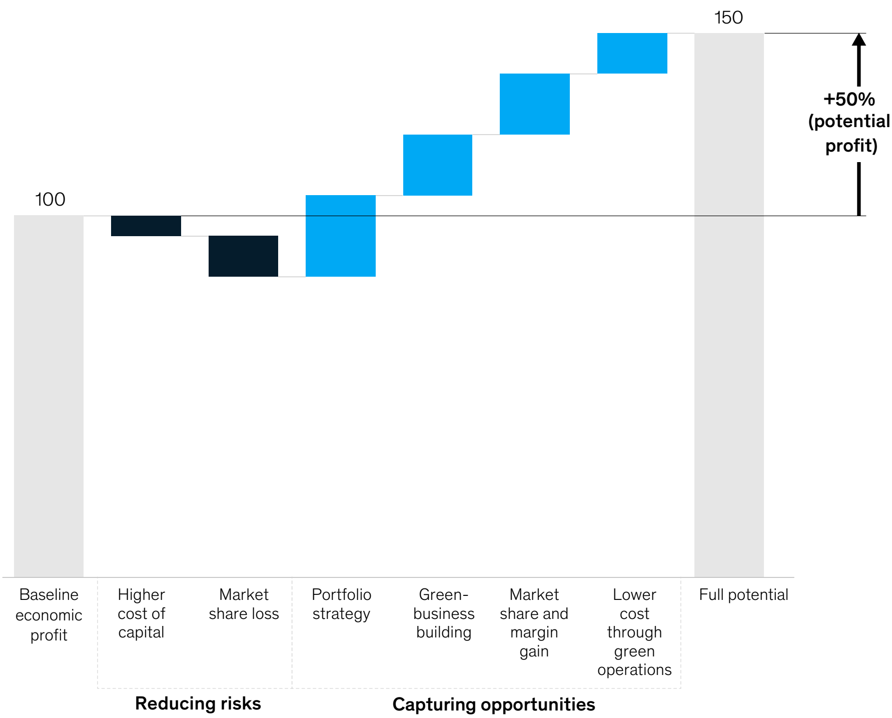
Reducing risks

A strong sustainability strategy reduces several downside risks companies might otherwise face (such as increased cost of capital and enhanced reputation of competitors) and can thereby provide an important source of value. By proactively working across the supply chain to reduce GHG emissions, grocers can avoid these additional costs. In addition, as consumers

Exhibit 4

Sustainability value creation levers can drive economic profit.

Illustrative economic profit, modeled with top-down assumptions, baseline = 100



Source: McKinsey analysis

increasingly patronize more sustainable companies, there is a risk of losing market share to sustainability leaders. By offering a wider range of healthy and sustainable options and by decarbonizing their operations and the value chain, for example, grocers can gain market share.

Capturing opportunities

Sustainability strategies can do more than mitigate risk and reduce downsides; such approaches can also give grocers a competitive edge and allow them to take advantage of new opportunities. We outline some potential strategies for grocers below.

Portfolio strategy. Grocers can begin reorienting portfolios toward sustainability at the level of their broader ecosystems. They can rigorously allocate capital—for example, by investing in sustainable parts of the business, managing unsustainable parts through cash flow, or scaling down and divesting—and think about organic and inorganic moves. There are many attractive sustainability value pools beyond grocery, often with significantly higher growth and margin potential. Grocers can evaluate the potential to extend beyond their core business, whether by focusing on adjacent segments that strengthen the core business (such as Australia's Woolworths, which acquired health food retailer Macro Wholefoods Market in 2009 and has since introduced more than 350 products to its stores, including its Macro Whole Living range for cleaning products, which has been certified by Good Environmental Choice Australia [GECA]) or by using consumer data as an ecosystem backbone to provide highly valuable services.

Sustainable-business building. Disruptive sustainable innovators are emerging in the food system, from vertical farming (such as Thailand's FlexiFarm, Malaysia's Farmy, and Singapore's ComCrop and Sky Greens) to protein alternatives (for example, Next Gen Foods' Tindle, a plant-based chicken) and packaging circularity (TerraCycle's Loop partnership with AEON in Japan). Yet established grocers typically struggle to build new sustainable businesses successfully. While they face real challenges, such as brand credibility and incubating agile new ventures within larger corporate structures, established grocers are also held back by a lack of ambition and an unwillingness to disrupt themselves before someone else does. These are missed opportunities. Established grocers have significant advantages that should make them the natural owners of sustainable-business building. Migros in Switzerland is leading on this front, with its Cultured Food Innovation Hub developing cultured meat, seafood, and more.[3] Meanwhile, Asian players are taking small steps. Examples include Vingroup with its sustainable-agriculture unit VinEco in Vietnam, Super Indo with its launch of certified-sustainable cooking oil in Indonesia, and Totoya with its first zero-waste supermarket in Japan.

Market share and margin gain. Consumer companies are increasingly gaining market share and margins by differentiating through sustainability. The three principal levers are branding and marketing, sustainable value propositions and differentiation, and green pricing—especially as sustainability premiums begin to materialize. For example, sustainability

[3] Annual detailed enterprise statistics for trade (NACE Rev. 2 G), Eurostat, May 18, 2022.

leaders disproportionately allocate shelf space and resources to sustainable products, which are outgrowing conventional products by a factor of seven.[4] On green pricing, grocers must ask how much consumers are willing to pay for green products. Michal Klar, general partner from Better Bite Ventures, said, "For an alternative-protein product to be successful with consumers at scale, it needs to meet their needs at three core levels: taste, price, and convenience."[5] Consumers perceive price to be an important factor in purchasing decisions, so grocers need to get it right.

Sustainable operations and supply. More sustainable operations can be value accretive and significant drivers of better performance. Often, we find up to 50 percent of operational levers can be net present value–positive (NPV-positive) or NPV-neutral and can improve financial performance through cost reductions.

[4] Randi Kronthal-Sacco and Tensie Whelan, "Sustainable Market Share Index," NYU Stern Center for Sustainable Business, March 2021.
[5] "Make room for alternative proteins: What it takes to build a new sector," McKinsey, March 25, 2022.

More sustainable operations can be value accretive and significant drivers of better performance.

Grocers should therefore approach sustainability investments as they approach other investments: by prioritizing the most economically efficient options. Grocers can use marginal-abatement cost curves to prioritize NPV-positive or NPV-neutral levers (Exhibit 5). Such cost curves show the cost of each investment and rank them by their return on capital.

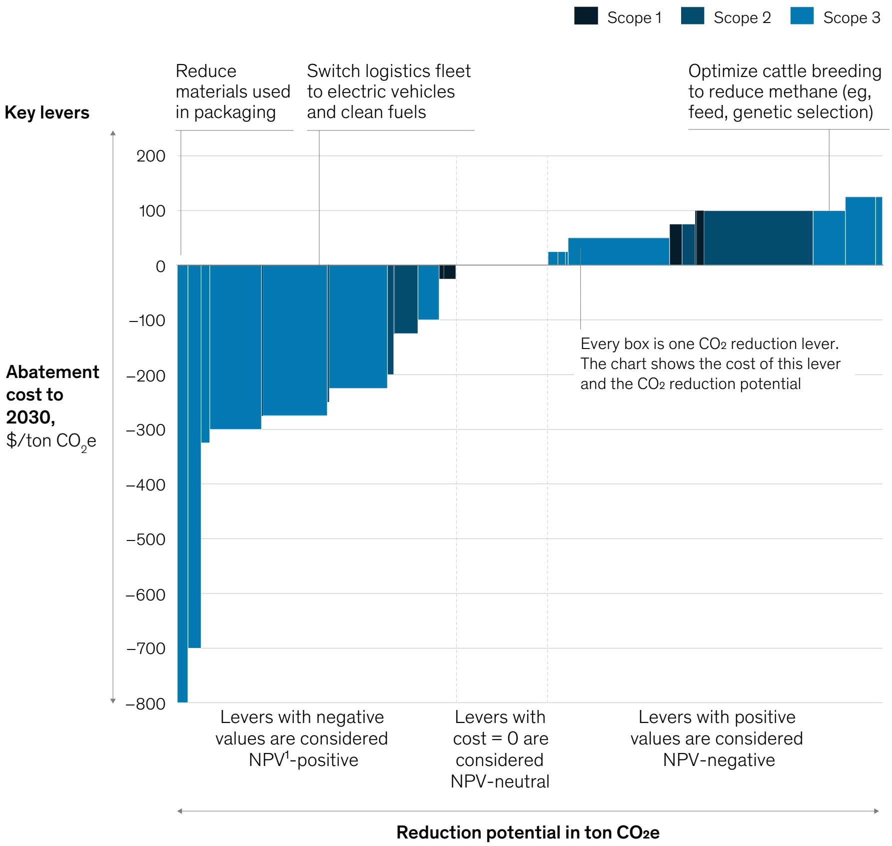
3. Setting up the sustainability transformation for success

Maximizing sustainability impact and value creation requires a holistic transformation approach with the right operating model. Like any business transformation, sustainability is hard to do because it requires a substantial number of changes

Exhibit 5

Carbon-abatement cost curves can support decisions about the sequence of implementation.

Exemplary marginal-abatement cost curve (MACC) for grocery retailers
Levers to abate CO_2-equivalent (CO_2e) emissions, 2030 view



Note: Additional potential from Scope 3 downstream levers not included.
[1]Net present value.
Source: McKinsey Decarbonization Lever Library; McKinsey GreenGauge; McKinsey analysis

to the business as well as cross-functional collaboration. Sustainability efforts should therefore be anchored by the CEO and board, who should model a green culture. They should be supported by a central team led by a chief sustainability officer who reports to the CEO and acts as the main orchestrator and know-how provider across the organization. Building a successful green business depends on four imperatives[6]: set a bold sustainability vision; double down on talent and culture; flex the operating model, with leaders modeling a bold, experimental mindset; and take an agile approach to risk capital, knowing commercialization of products and services won't happen overnight.

The food system requires fast, systemic change to become sustainable. Grocers can be a driving force and create significant additional value, but this is a multiyear challenge. We recommend three steps that leaders should take now:

- Assess your sustainability baseline and define your sustainability ambition with concrete impact targets (such as financial, carbon abatement, waste diversion, and supplier engagement). These should be based on your starting point, your purpose and internal "appetite to do good," the behavior of competitors, your stakeholders' expectations, and the resulting potential for value creation.
- Implement a well-defined and prioritized set of sustainability initiatives that maximize your sustainability impact across the HE^{2}AL dimensions and generate value for your business across all six types of value creation levers. Think strategically about how to involve suppliers, differentiate through sustainable own brands, and invest in transparency.
- Adapt your operating model to anchor sustainability in the day-to-day business decisions most relevant to your articulated ambition across the value chain. This enables consumers to make sustainable choices, optimizes your operations, and allows you to collaborate with farmers, suppliers, and peers.

By taking these actions, grocers in Asia can lay the groundwork for a successful, sustainable future.

[6] Harry Bowcott, Philipp Ernst, Anna Heid, and Philipp Hillenbrand, "Building a green business: Lessons from sustainability start-ups," McKinsey, April 27, 2022.

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