OLIVER WYMAN

COMMERCIAL RESET IN CONSUMER GOODS

Responding to the structural P&L impact of COVID-19

TEN IMPERATIVES FOR ADAPTING YOUR P&L TO NEW REALITIES

After several weeks of store lock-downs, and only very gradual store re-openings, the impact of COVID-19 on consumer goods businesses is becoming increasingly clear. Apart from the immediate downturn in revenues, the crisis has driven structural changes to the way consumer goods markets will function going forward, with major implications for company Profit and Losses (P&Ls). Consumers have step changed adoption rates in the online channel — the result here has been a massive and adverse structural mix effect, impacting in the short- and long-term not only a manufacturer's top line, but also gross profit rates. Oliver Wyman analysis points to a major shift in consumer demand towards relatively lower-priced products in online consumption. If this shift persists, consumer goods companies could well suffer an enduring loss of two to three percentage points in relative gross profit. These trends represent major threats to profitability, and even long-term viability. This article provides ten imperatives for consumer goods companies looking to manage the ongoing COVID-19 upheaval successfully.

The spread of the COVID-19 virus has generated unprecedented disruptions to daily life and economic activity. In a matter of weeks, the impact of these disruptions is emerging in sharp relief.

Retailers have not only suffered from immediate revenue losses, which are likely to be sustained, but also (massive) overstock. For the fashion industry, aging Spring collections no longer in demand lie piled on the shelves of thousands of stores. Due to these severe revenue losses, retailers will have no hope of achieving annual sales targets for 2020, and hence not receive substantial amounts of trade incentives from their suppliers.

Consumer preferences have changed with lightning speed over the past weeks, triggering a stream of knock-on effects for consumer goods companies. These changes are multi-dimensional, ranging from channel shifts in consumer buying behavior to lower consumer spend levels. They also have affected the specific product segments and features which consumers are now looking for. Consumer data across a range of countries tells a common story — consumer spending has moved strongly towards the online and mobile channels by between five and ten percentage points. In consumer electronics, for example, online penetration in Europe jumped from 18 percent pre-virus to a steady 30 percent and holding.

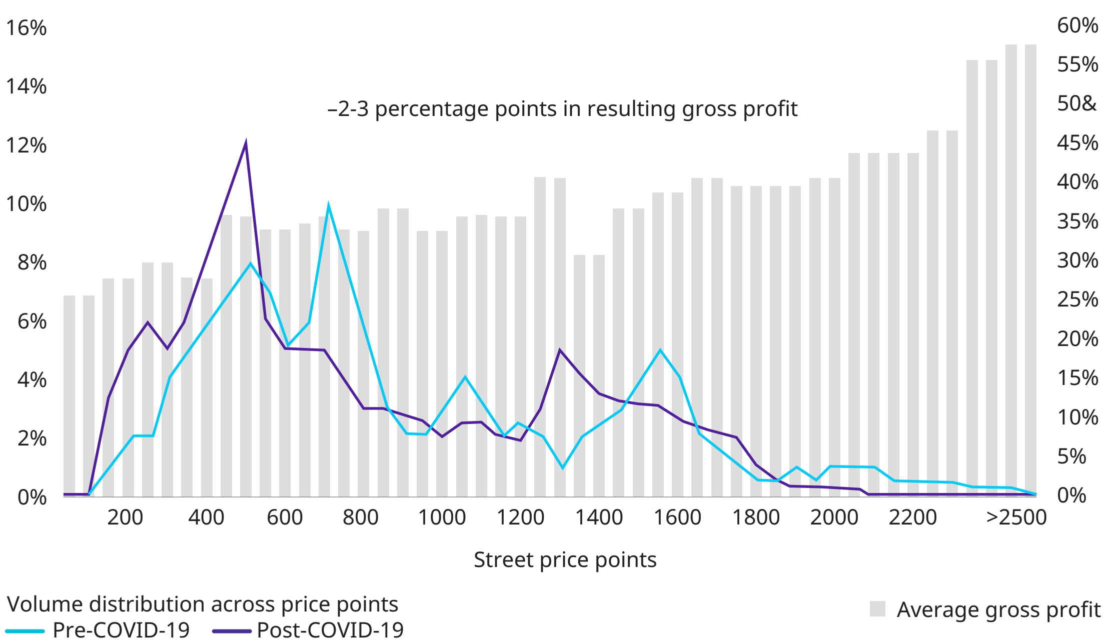
Consumer goods manufacturers have suffered not only from immediate revenue losses, as well as changes in consumer behavior — they also are reeling from what looks to be sustainable disruption in their P&L structure and economics. Long-term experience tells us that consumers purchasing online tend to be more price-sensitive, and less inclined to buy high-end products. If the channel shift proves to be structural, not only premium brands but essentially every branded player can expect to experience adverse effects on structure and mix in their product architecture. If indeed retailers choose to shift volumes long-term away from the high-end products which are — in most cases — the true margin drivers for the industry, the economic consequences for consumer goods companies could be profoundly negative.

Despite the grim nature of the current situation, history has shown that companies can survive a crisis, and emerge stronger. We believe the companies which respond faster to the ongoing tectonic market shifts, who manage the crisis better, and who change their models effectively will win. But how? In the following, we provide our take on how best to navigate current stormy waters.

To evaluate the effect of COVID-19 on consumer buying behavior in Europe, we examined channel preference shifts in consumer appliances, small domestic products, as well as entertainment and media, and estimated the impact of these shifts on company P&Ls. The message was consistent across segments and sobering — a contraction of two to three percentage points in gross profit for a branded consumer goods manufacturers.

An example of the threat can be found in the following chart, which shows the sell-out pattern pre-COVID-19 versus post-COVID-19 for a branded manufacturer of television sets. A massive increase in online channel purchasing pushed the volume mix towards entry- and mid-level price points. For this company, sales were achieved at a lower average "street price," and gross profits contracted from about 38 to 35 percent.

Exhibit 1. Changing search consumer purchase patterns, driven by the online channel shift



Consumer goods companies need to revisit their commercial blueprint across every line item of the P&L. Market shares shift in the years following events, such as COVID-19, are seen to be three times as high as in stable times. Companies which respond fast to tectonic market shifts and crises are more likely to emerge as the winners from such a situation. While every sector and every company will face a different set of challenges and opportunities, we defined ten imperatives for consumer goods companies to emerge as a winner.

1. CREATE A FUTURE-PROOF CHANNEL STRATEGY

Over the past ten to fifteen years, most consumer goods sectors (with the exception of sporting goods) have relied upon third-party trade partners as the main route-to-market. Attempts at developing alternative distribution models, for the most part, failed to go beyond the trial stage. At the same time, retail landscapes have consolidated around fewer trade partners, while “bricks and mortar” retail businesses have seen more and more pressure from online challengers and marketplaces.

The store closings driven by social distancing directives have highlighted the risks of relying only on third-party retailers. Consumer goods companies will have to strategically revisit their channel strategy in light of the recent crisis. They need to reassess the commercial potential of various alternative routes-to-market, whether fully owned channels or managed ones. This process will also need to reassess direct-to-consumer models, considering that these have a positive gross profit differential of some ten to fifteen percentage points vis-à-vis using third party retail.

The aftermath of COVID-19 should act as a forcing function for making an essential and time-critical decision: which trade partners do we want to support and stabilize going forward, and which ones do you not? And how can we use this phase of uncertainty to generate a competitive advantage by creating stronger ties to those trade partners we want to invest into? The answers to these questions could entail previously unthinkable measures such as providing very prolonged payment terms, much greater trade investments, or even a co-ownership of businesses.

2. RESET THE PARTNERSHIP WITH THIRD-PARTY TRADERS

Most, if not all, retail businesses will suffer at least threefold in 2020. First, there are the effects of imposed store closures. Second is the highly likely contraction of consumer spend for the remainder of 2020. Third is the negative impact on trade investment levels from suppliers — retailers will be unable to achieve volume targets and pay-for-performance trade spend components.

The fact that hardship is joint should allow retailers and suppliers to fundamentally revisit their relationship. To counter the negative mix effect due to a decreasing relative consumer spend in the online channel, both parties need to develop a dedicated “premiumization strategy” for the online channel, which is urgently needed, given the common trading down patterns in the online channel.

Key elements of a partnership should be on providing mutual financial support and tackling pressing supply chain issues. Companies such as Nike have already started to engage with many of their

European trade partners, in particular smaller chains, to help stabilize their businesses. And others, such as JD.com, have launched dedicated programs such as the "Spring Raindrop Plan," which allocates substantial amounts of money to support partner brands in the form of content marketing activities, special sales, live streaming support, and coupons. Most importantly, suppliers will need to support their trade partners in clearing overstock, running effective post-crisis promotions, and delivering the right products at the right time. Now is the time to walk the talk.

3. ADDRESS THE CONSUMER IN A MORE DIRECT AND ENGAGING WAY

In a crisis, sending the right messages to consumers can evolve into a multiplying blessing or, if neglected, a curse. Whilst some companies lost significant consumer franchise overnight — for example, as the result of immediate staff layoffs, rent payment freezes or canceled supplier commitments — others have gained enduring sympathy. For example, global hotel chain Marriott announced early into the crisis that all of the company's BONVOY loyalty program members would receive an unconditional extension of their current membership tier until 2022. Amidst the financial crisis of 2009, carmaker Hyundai launched a "peace of mind" program that covered insurance for up to six months if consumers lost their jobs. Such activities provide an effective — perhaps the most effective — singular opportunity to create a competitive advantage by strengthening decisively positive connections to a brand.

Similarly, consumer goods companies with robust and closely-knit loyalty and Customer-Relationship-Management (CRM) capabilities have emerged as another group of winners in previous crises. For example, Starbucks Coffee has been investing heavily in consumer engagement over the past 10 years, including state-of-the-art data mining and pattern recognition capabilities. In the early days of the US COVID-19 outbreak, the company ramped up communication to all its registered consumers across all channels, as well as offering new services such as free deliveries via UBER. In China, Nike managed to limit the commercial impact of wide-spread store closures across its 7,000 outlets thanks to strong consumer engagement. Despite the store lock-down, the company managed to connect with its consumers via a combination of the company's corporate app, training programs, WeChat presence, and other channels, all seamlessly linked via a Single Nike membership ID.

Not only during this crisis, but also in a post-COVID-19 era with a high online share, tightly knit consumer engagement can and will secure loyalty and higher returns.

4. ADAPT PRODUCTS TO THE NEW MARKET REALITIES

Even before COVID-19, consumers had been changing faster than ever and becoming more demanding in the level of tailoring expected. Overnight, the pandemic has brought up new concerns and needs — for example, hygiene, disinfection, and personal safety have become critical purchasing decision criteria.

For consumer goods companies, short-term and medium-term reactions need to differ. In the short-term, adapting messaging around existing products will be essential. For example, in China, durable goods players who shifted communication towards hygienic product features, and products such as disinfection and degerming were rewarded with corresponding spikes in sales and views.

Over the mid-term, manufacturers need to assess which of the COVID-19 trends are here to stay and act accordingly. Looking to markets further along in the crisis can provide insights here. In the nutritional space in China, for example, consumer interest in products associated with immunity benefits (such as probiotics) soared and has stayed at a high level, a shift which we expect to be sustained.

The coming global recession will put pressure on consumer spending and challenge long-held strategies of “going premium” as a way to maintain margins. Manufacturers will need to shore up their competitiveness in entry price points, and potentially focus their investment in a smaller number of premium innovations to fit with consumer spending power. Given a likely trading down trend in consumer spending, manufacturers will need to consider “de-featuring” products to help protect gross profits from eroding. In addition, alternative payment offers, such as subscription models (including free trials) and pay-per-use models will help to lower the bar for consumers.

5. OUTCOMPETE COMPETITION

Whether they relate to improving trade partner relationships, direct consumer interactions, or changes to the product portfolio, the measures discussed above can allow companies to realize a competitive advantage during this crisis. But there are more.

A critical lever here relates to branding and communication, and the key messages companies convey to consumers. Fundamentally supportive messages such as “we are in this with you” will make a difference during and after the crisis. Such sentiments should be coupled with unique assets to capture consumers. In China, we have seen this range from providing free services (such as Nike and Lululemon offering free or discount training via APPs) to creating a new route to market — one key element here will be brands leveraging their store staff to enable and expand direct delivery to the consumer.

Also, companies able to exploit technology effectively will gain a lasting competitive advantage. Several Chinese companies — almost overnight — gained double-digit market share by training their sales force in “live selling,” and continued with this model even after stores reopened. Beauty company FOREST LOG CABIN trained over 1,600 full-time employees in live/video-based selling, managing to increase sales by 45 percent like-for-like. The Shanghai Fashion Week decided to modify their event by video streaming its fashion show to consumers and companies across the globe, rather than canceling, in contrast to many other fashion events.

6. ENGAGE WITH BUSINESS PARTNERS IN A NEW WAY

One of the most consistent learnings from past crises stems from how some executives took on a pro-active leadership role in dealing with their trade partners across the value chain. A company cannot emerge from a crisis as a winner by "passing the buck" to business partners, companies typically more fragmented and less powerful as one moves up the value chain.

Helping trade partners should not be confused with engaging in altruism. Rather, companies need to consider dispassionately their level of exposure to partners such as independent suppliers (parts or finished goods), suppliers of intellectual capital, logistics providers, and other players across the supply chain — and the costs of losing them. Based on such an assessment, companies can then prioritize investments toward core partners, whether this is a pure cash contribution or a more fundamental deal, which might involve some level of exclusive access to the partner's resources and capabilities.

Former President and Chief Executive Officer of Victoria's Secret, Sharen Turney, successfully led her company through the financial crisis of 2008 and said, "You will notice that business partners don't forget your support in times of crisis. On the flip side, companies that simply passed the buck down the supply chain only realize over time how much they lost out on this window of opportunity."

7. RESET YOUR COST STRUCTURES

In the current crisis, with several retailers having stopped or delayed payment as cash flow dropped close to zero, liquidity management has been the number one short-term priority for consumer goods companies. Cash outflow has been reduced where possible, and credit lines have been extended. But there is an additional crucial priority issue — managing receivables risk. Many retail customers are short on cash, so being able to offer better payment terms than competitors will be a critical success lever for sales teams.

In the midterm, it is advised to create an adjusted P&L structure across all line items representing the market changes induced by COVID-19, thereby tackling required action from the top, not from the bottom. As mentioned above, the revenue and also the gross profit will suffer as a result of the current crisis. A sustainable shift towards the online channel will result in a gross profit contraction of several percentage points due to adverse product mix/structure effects.

To close the gap to a sustainable future P&L, incremental cost measures alone are necessary, but not sufficient. Whilst levers addressing overall headcount or indirect spend categories are common, the new target state is most likely to be achieved only via structural changes across the operating model and all P&L line items. For example, key levers will center around the digitization of marketing activities, not just cutting budgets. Along a similar vein, the sales function will require a new target picture, related to the coverage of bricks-and-mortar retailers, not just cutting resources.

8. PREPARE YOUR SUPPLY CHAIN FOR NEW REQUIREMENTS

Most consumer goods companies have invested significantly to upgrade supply chain capabilities in recent years. These initiatives were often geared towards cost reduction through better forecasting systems, LCC sourcing and manufacturing strategies, or a reduction of lead times for retail or end customers. The current crisis will set the bar even higher, for example, related to direct shipment capabilities for small lot sizes, as needed for direct-to-consumer businesses.

The even more pressing question for executives will now be on how to handle overstock or aging stock, as is the case in the fashion sector. Trade-offs will have to be made to allow for "decent" sell-through of previous models vs. emerging from the crisis with fresh merchandise. It will be key for consumer goods companies not to rely solely on standard clearance approaches — creativity and innovation will be required. Possible approaches include revisiting launch cycles, storing seasonal products for next year, or transshipments into other markets.

Finally, it will be important to draw the right learnings from the crisis. The 2008 financial crisis resulted in a race for supply chain speed, and faster supply chains have proven to be more responsive to volatility in demand. Given the contraction of consumer demand on the one hand but increasing supply chain requirements by business partners and certain channels, like direct-to-consumer, consumer goods companies need to strike the right balance between short-term need for cost reduction and longer-term competitive differentiation.

9. CREATE ORGANIZATIONAL READINESS

Given the comprehensive structural nature of the changes likely to come, executives will need, if not be forced, to revisit fundamentally the organizational framework along three critical dimensions:

First, companies must consider re-balancing priorities within and across functions. For example, resources within the sales department will need to be shifted towards the online channel, leaving questions about the role and requirements for the traditional sales teams. Across functions such as sales and marketing, the need to create a much stronger cross-functional connection may well emerge as a key requirement for success going forward.

Second, overall resource levels will need to be questioned hard, and be a key area of scrutiny for the executive teams. Often, consumer goods companies allow complex organizational setups to evolve and entrench themselves over the years across geographies, products, sectors, and oftentimes brands or business lines. Along these dimensions, an internal race for primacy took place, often leading to a proliferation of resources just to serve and respond to their respective counterparts. Resetting and simplifying the organizational construct is likely to be a key priority going forward post-COVID-19.

Third, the extended phase of working from home in 2020 has provided a lesson about more flexible, more digital, and potentially more efficient working methods. And it has opened up further degrees of freedom for flexible ways of working, that part-time talent, working moms, or others may prefer. During this crisis, we are seeing many companies that have not met the challenge of enabling effective work at a distance. Notable examples have been companies unable to equip staff with laptops for working at home, which resulted in almost complete loss of human resources when governmental decrees shut down corporate offices indefinitely. Learning the lessons of distance working, what needs to be in-office and whatnot, and how technology can re-define ways of working will be crucial elements of post-COVID-19 agendas.

10. SHOW GENUINE LEADERSHIP IN TIMES OF CRISIS

Above all else, strong and genuine leadership will be essential for companies to emerge from this crisis intact and ultimately stronger than before. No commercial reset in consumer goods can be achieved without in-depth analyses, making trade-offs, and providing forward-looking guidance. None of the opportunities are without risks — each requires careful balancing of short-term financial requirements and mid-term competitive benefits. Corporate leadership teams must create full transparency about what is at stake for their companies and employees. They need to be ready to be the face of the crisis in times where employees are physically remote from their workplace. This will require the use of modern technology, which many executive teams do not yet feel comfortable with. Elements such as personal videos from home, Q&A sessions via videoconference and even personal Linkedin posts have received outstanding feedback over the past weeks and should stay in place, even after the immediate lockdown. For example, Microsoft's Chief Executive Officer, Satya Nadella, has been praised by his employees for his authentic and emphatic leadership style over the past weeks, including weekly messages to all staff via different media. Whilst many of these activities were triggered by the current crisis, executives have pledged to maintain a new communication style also once they move into the new normal.

We designed this publication to cover the most relevant levers to turn a crisis into an opportunity. It is designed to be a cookbook with various elements to mix and match, rather than a recipe for just one specific meal. Corporate management teams select an individual set of aspects and turn these into their very own transformation plan. As the COVID-19 crisis continues to emerge, Oliver Wyman will continue to provide guidance on any of the 10 aspects of readiness illustrated above.

ABOUT OLIVER WYMAN

Oliver Wyman is a global leader in management consulting that combines deep industry knowledge with specialized expertise in strategy, operations, risk management, and organization transformation.

In the Retail & Consumer Goods Practice, we draw on unrivaled customer and strategic insight and state-of-the-art analytical techniques to deliver better results for our clients. We understand what it takes to win in retail: an obsession with serving the customer, constant dedication to better execution, and a relentless drive to improve capabilities. We believe our hands-on approach to making change happen is truly unique — and over the past 20 years, we've built our business by helping retailers build theirs.

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