Oliver Wyman

ADDRESSING THE PRIVATE LABEL DILEMMA IN RETAIL

Time to act now!

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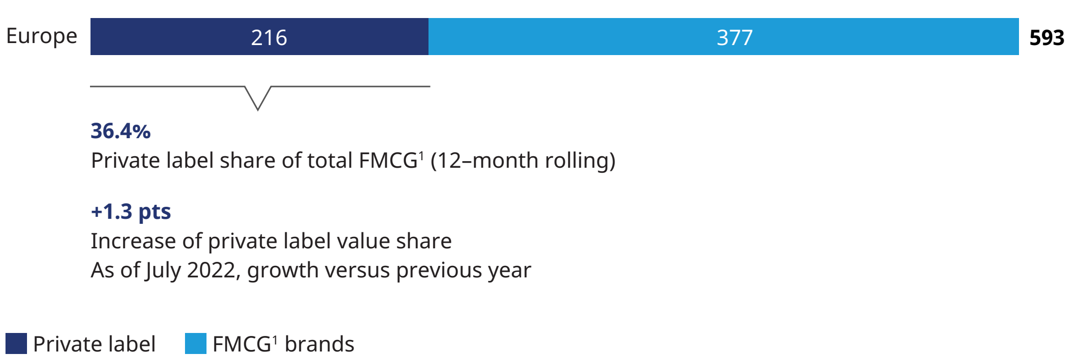
On top of inflation-induced cost price volatility, retailers are now facing the fallout of consumers shifting to less-expensive channels and product ranges. The latter has cost European retailers more than €700 million of annualized commercial margin already, turning many private label portfolios into liabilities within just 12 to 18 months. As consumer spending may not return to pre-2022 levels for several years, it is critical for retailers to address this challenge seriously and head-on. This report highlights actions to consider based on our experience working with retailers over the past decades.

THE PRIVATE LABEL DILEMMA TODAY

Private label lines have been a key play for most retailers — many have invested heavily in value products as entry-level ranges to combat discounters, as well as in better and best lines to differentiate from peers. To support their ambitious private label share targets, retailers dedicated efforts to develop sophisticated sourcing, product management, and marketing capabilities. The strategy not only resonated well with consumers during times of stable income growth, but also strengthened retailers' bargaining power in negotiations with brand manufacturers.

In 2022, however, inflation and high interest rates affected disposable income and forced consumers to "trade down" to lower-priced products. As it will take years for consumer spending power to recover the industry should plan for a continued shift downwards in the foreseeable future.

Exhibit 1: Private label value share of total FMCG[1] in Europe
In billion euros

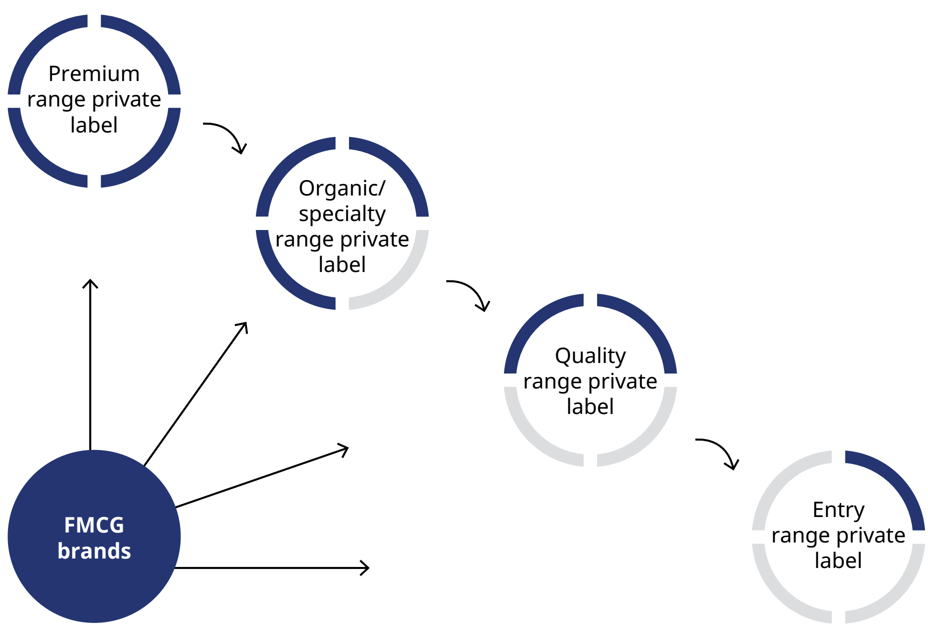


1. Fast-moving consumer goods
Source: IRI "demand signals" (October 2022)

At first glance, the growth of private label is good news. As cheaper alternatives to branded products, private labels can slow the shift to cheaper competitors or channels, while also helping consumers through the cost-of-living crisis. However, that is not the full story:

- **Entry range growth dilutes profitability**
  Entry ranges are an expensive "defense mechanism": They allow for a consumer top-up on spend that would otherwise have gone to discounters, but at a lower margin that is only affordable with low volumes. Now that volumes are growing faster than expected, the affordability of such mechanisms is in question — the cannibalization of more expensive lines by entry-level ranges spells disaster for overall commercial margins.
- **Continued pressure on entry range prices and margins**
  As discounters expand share and strengthen their cost advantage by keeping prices low and gradually raising product and quality standards, retailers are facing a volume shift toward discounters and have a tough choice to make: follow on price and quality and take a margin hit, or improve margins but have a greater price disadvantage and a loss in volume.
- **Slippery "trading down" slope**
  Today consumers can easily trade down well-crafted "product ladders" (that is, ranges of products varying in price and features). This leads to volumes steadily flowing to the bottom of the range, which negatively impacts margins.
- **Better and best private label ranges under pressure**
  Volume declines in key parts of private label portfolios cause financial turmoil, with business cases increasingly under water, volume commitments to suppliers spiraling out of reach, and consumers turning a cold shoulder to brand messaging.

Exhibit 2: Switching from brands to private label ranges, and within private label ranges



Source: Oliver Wyman

As a result, while the first wave of challenges rooted in the return to inflation has been difficult to absorb, this second-order effect will create even more challenges. First, commercial margins will continue to be under pressure. The mix change has already cost the European food retail sector north of €700 million annualized commercial margin.

Second, the strategic intent behind added-value private label lines is clashing with the new reality of crumbling volumes during the cost-of-living crisis. Retailers must therefore decide how to continue differentiating through private label while increasing scale and improving economics.

Exhibit 3: Two waves have impacted the profitability of retailers

First wave **Centred on buying and selling prices**			Second wave **Driven by consumers trading down**		
COGS[1] increases	Tough negotiations	Selling price volatility	Prevailing cost-of-living crisis	Private label entry range growth	Private label volume erosion at top end
Intensified price competition	Public pressure on prices	…	Volumes slipping down	Margin erosion	…

1. Costs of goods sold
Source: Oliver Wyman

All evidence suggests that there is no easy solution to restore margins. Therefore, we suggest addressing the issues heads-on. Our Private Label Playbook includes a comprehensive set of recommendations for doing so effectively.

IMMEDIATE ACTIONS TO IMPROVE PRIVATE LABEL MARGINS

Stop the margin erosion and enhance the ability to act based on better control and steering of product-switching dynamics

1. Perform a rapid private label assessment

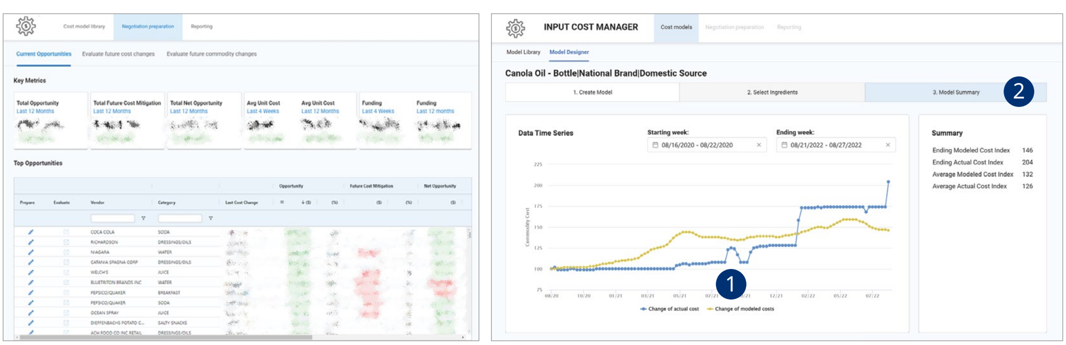
Start by answering the following questions:

- What are the direct and indirect results of mix-changes? What is our risk exposure to subcritical private label lines now and in the next two years?
- What are the underlying switching dynamics? Where and what are the biggest drivers of down slippage? Which private label lines and brands are proving to be ineffective in moments of crisis?
- What is the strategic intent of higher-value-added private label lines?
- What sourcing capabilities does the company have internally, and how can they be improved?

2. Get on top of own-label cost of goods sold and commodity cost opportunities

Gain a deep understanding of input cost evolution across all private label products to pursue potential cost-reduction opportunities as early as possible. An automated, artificial intelligence-led approach will help navigate complexity, anticipate cost risks and opportunities, and provide leverage in negotiations with manufacturers.

Exhibit 4: How Oliver Wyman cost model libraries can accelerate input cost tracking



1. Breaking down the costs of a given private label product allows to track its evolution and identify opportunities
2. Especially as a lot of commodity prices start reducing today, there is an opportunity to improve product costs

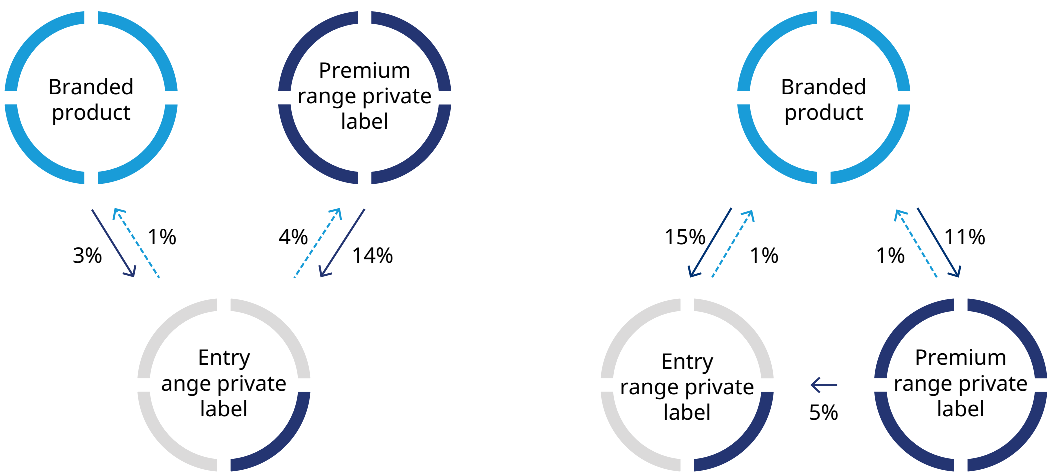
Source: Oliver Wyman

3. Run fast-track category resets based on a thorough understanding of product switching

The way products are allocated to assortment modules, placed in stores, and priced relative to each other can change switching dynamics substantially and slow down, if not stop, slippage (while preserving price perception targets):

- Reviewing, potentially adjusting the role of private label in each category
- Understanding switching dynamics by product group/category/range module — and gain an ability to stimulate future volume flows
- Run tactical optimization of assortment, adapting to the shifts in consumer behavior
- Leverage the additional insights in negotiations

Exhibit 5: Examples of switching dynamics and trading down



Dairy
High level switching from premium range private label to entry range private label

Sweet snacks
High level switching from branded to premium and to entry range private label

Note: XX% = Switching rate from product A to product B, i.e., the probability distribution of expected spend towards product B for customers' next trips after purchasing product A

Source: Oliver Wyman

PRIVATE LABEL CHANGES FOR THE LONG TERM

The current crisis is a reminder that the substantial enhancements to private label management capabilities of the last decade are just the beginning. In most cases, there are still gaps to fill in product management, operations, and scale.

1. The next private label customer proposition

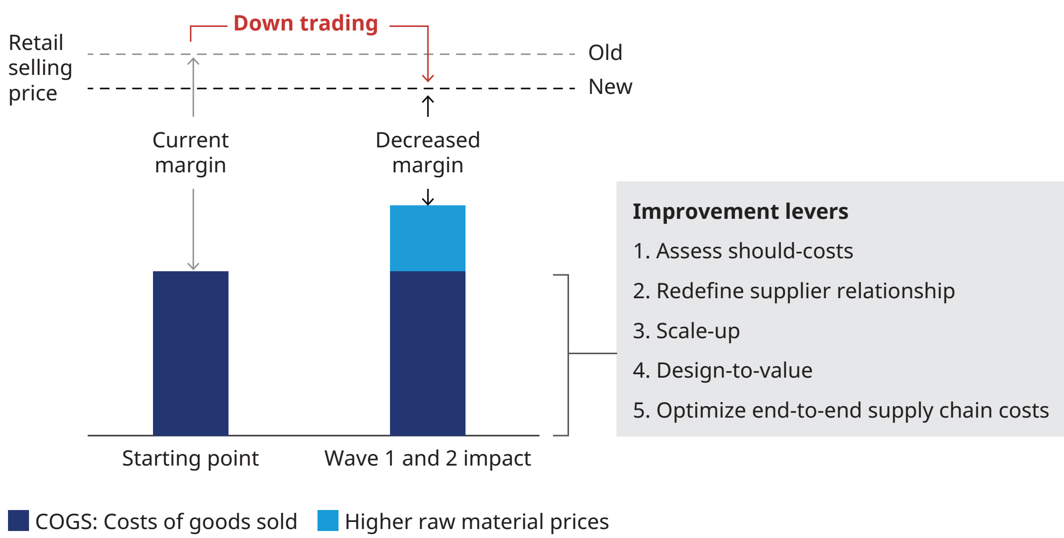
Now is the time to review and challenge past assumptions, reconsider what to grow, reposition, or where to exit. Shall we keep the tiered approach? Or move to a more condensed portfolio, with less variety? Is the brand approach still right? Where to focus on expanding choice or on consolidating volumes?

Operational guardrails and targets for quality management and pricing should be established based on the strategic answers, in each category and channel/format, and with sufficient granularity to feed assortment optimization tools.

2. Develop true product cost-management capabilities

While most retailers have substantially upgraded their approach to private label sourcing, it still often remains a "buying approach," reliant on third parties. The future challenge will be to move toward a true product company mindset that considers customer proposition, product cost, and supply chain as one. This requires deploying **should-cost** (that is, projection of total product cost if efficient manufacturing and distribution practices are followed) and **design-to-value** (that is, design approach that aims at maximizing value generation) approaches to achieve significant cost reduction. And in turn it requires a different approach to upstream supply partners and to the whole **farm-to-fork** process.

Exhibit 6: True product cost management capabilities are required to mitigate margin drop



Source: Oliver Wyman

3. Get real in terms of scale

Only pan-European discounters or the largest retailers in two to three European markets enjoy true scale benefits, while many others struggle with their private label portfolio. Retailers should increase their focus on volume bundling within retail groups and across borders through alliances to combat margin erosion. Making this a success requires explicit top-down guidance and incentives to break through internal resistance.

Since 2022, retailers have mostly been reacting to COGS inflation via negotiations and pricing. As the dust settles, it's becoming clear that retailers face another wave of challenges driven by consumers trading down to the bottom end of their private label portfolio. This opens gaps in their P&L, while the declining volumes in the upper parts of the portfolio raise core strategic questions. The time has come to review assortment and private label propositions, as well as underlying capabilities, to navigate the storm successfully.

Please reach out to Oliver Wyman should you be interested in exploring the shared perspective.

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