WHITE PAPER

Setting Up for Retail Success as Inflation Eases

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By Ken Davidson and Jamie Brindley

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Setting Up for Retail Success as Inflation Eases

As the supply-constrained, inflationary market of 2021-2022 shows signs of improvement, retailers in the US and Europe have an opportunity to improve customer value by refocusing on cost and price fundamentals. They should review their cost structures aggressively and take several steps to set themselves up for success—focusing on sourcing and supplier management, assortment reviews, pricing, and customer communications. Importantly, time is of the essence, since other retailers will be doing the same.

Headline inflation beginning to stabilize as inflationary drivers come down

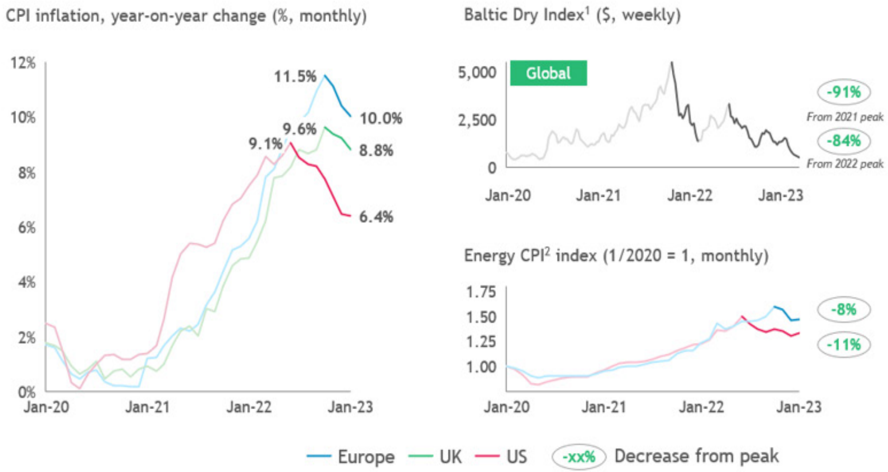
Consumer Price Index (CPI) inflation in the US and Europe continued to decline in the first month of 2023, down 2.7 pp from its 9.1% peak in the US in June 2022 and 1.5 pp from its 11.5% peak in Europe in October. This downward trend was underpinned by supply-side deflation, including:

- A decrease in the US consumer price index for energy of 11% in December 2022 relative to its peak in June 2022, along with a reduction in the EU consumer price index for energy of 8% from its peak in October 2022
- A 91% decline in global shipping costs from their two-year peak in October 21, as measured by the Baltic Dry Index, bringing shipping back to pre-pandemic cost levels
- The beginnings of a slowdown in labor-cost increases in the EU and the US in the third quarter of 2022, according to Eurostat and the US Bureau of Labor Statistics, respectively
- Decreases of up to 47% in prices for input commodity classes such as cotton, wheat, oil, coffee, and corn from their 2022 highs as of February 2023 (See Exhibit 1).

Exhibit 1 – as inflation cools, some cost drivers are decreasing significantly

Headline CPI inflation peaked in late 2022 and is decreasing

Many input costs have peaked and are deflating in real terms



Some commodity prices have dropped significantly from peak

Commodity future	Peak price (¢)	Current price (¢)[3]	Decrease from peak (%)
Wheat *(per bushel)*	1,294	750	-42
Corn *(per bushel)*	818	674	-18
Cotton *(per pound)*	155	82	-47
Coffee *(per pound)*	252	190	-25
Soybeans *(per bushel)*	1,732	1,534	-11
Sunflower oil *(per quintal)*	2,536	1,488	-41

1. The Baltic Dry Index is a global benchmark for moving raw material commodities by sea; it takes into account 23 shipping routes and 3 dry bulk carrier sizes reported on the Baltic exchange

2. CPI for energy, US cities' average; Harmonized CPI for energy, Eurozone

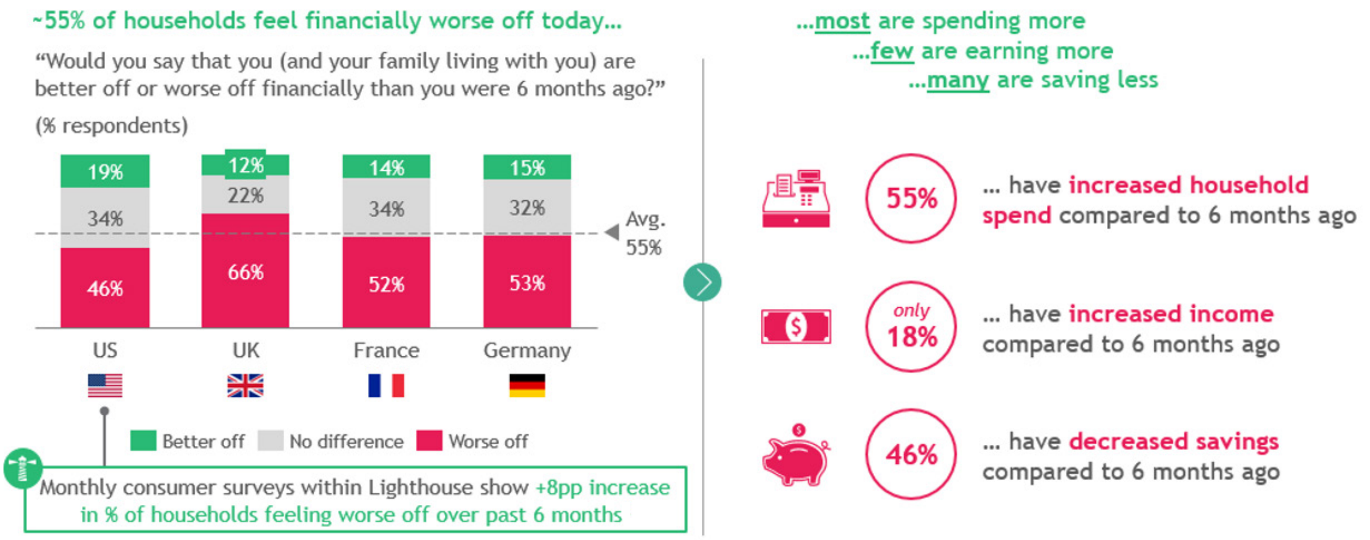
3. As of 2/22/2023

Source: BLS; UK Office of National Statistics; Eurostat; Chicago Board of Trade; New York Board of Trade; St. Louis Fed; Trading Economics

Consumers have begun reacting to inflated prices

Even as the most acute phase of the pandemic eased in 2021-22, rising inflation created renewed volatility. A BCG survey of American and European consumers reveals that 55% of respondents were forced to spend more and felt financially worse off in September 2022 than they did six months prior (see exhibit 2).

Exhibit 2 – 55% of households stated that they felt financially worse off and were forced to spend more than they did half a year prior

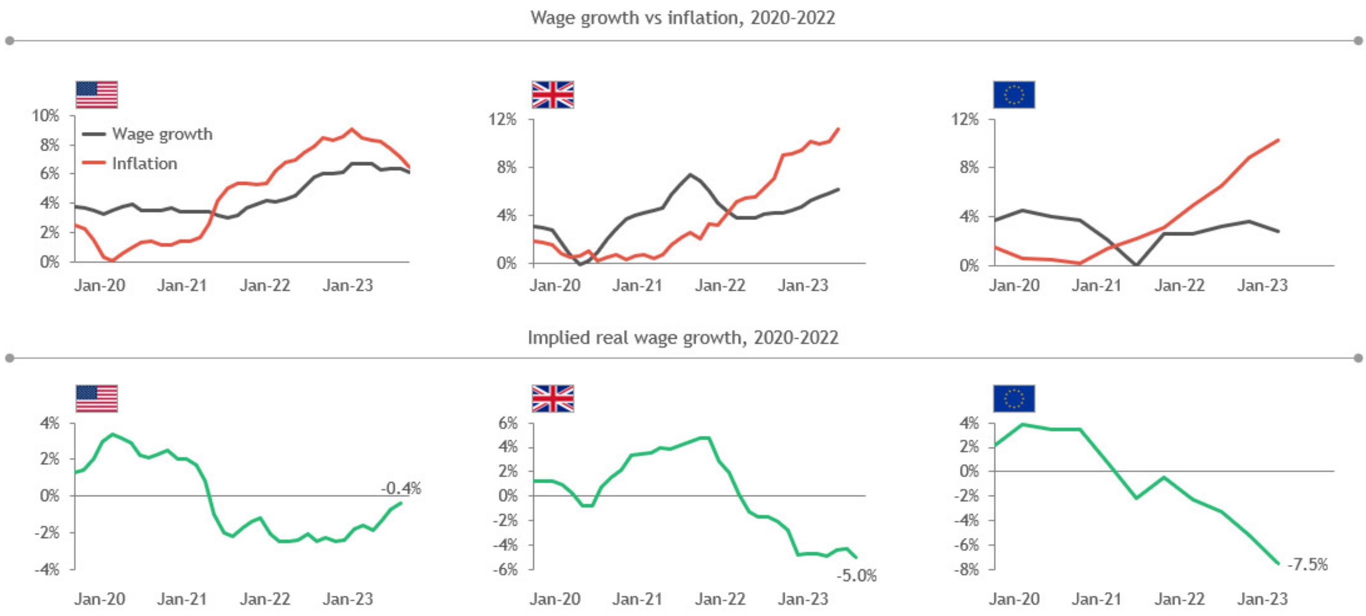


Note: Net change is equal to percentage of respondents that spend a lot less or somewhat less minus the percentage that spend somewhat more or a lot more

Source: BCG Recessionary behavior Consumer Sentiment Survey, Aug 2022 (n = 2,041 for US, n=2,146 for UK, n=2,571 for France, n= 2,504 for Germany, unweighted); BLS; i360 Longitudinal Consumer Survey in Lighthouse

Indeed, purchasing power has decreased significantly after over a year of inflation outpacing wage growth (exhibit 3), and with economic indicators not forecasted to grow quickly, consumer confidence indices today remain at levels below the worst of the COVID-19-induced lows of 2020, according to the Organization for Economic Co-operation and Development (OECD).

Exhibit 3 – Consumers’ purchasing power has decreased significantly after over a year of inflation outpacing wage growth



Source: Bureau of Labor Statistics; Federal Reserve Bank of Atlanta; US Census Bureau

In response, consumers have taken up new strategies. Firstly, they are purchasing less; a Mintel survey of consumers in six European countries from October 2022, 52% of respondents said that they are buying fewer non-essential products as a reaction to inflation.

Consumers are also showing an increasing willingness to trade down to cheaper or discounted products to maintain similar spend levels on the level of the whole basket. Mintel found that 41% of respondents planned to buy more private labels to decrease price points, and in BCG’s survey from September 2022, when asked what overall strategies they are newly taking up in response to inflation (if any), 70% of respondents explicitly stated that they have begun looking for more deals and promotions – the highest of any answer option provided.

This also leads to higher uptake of private labels: private label growth is especially strong in Europe, with Germany and Spain experiencing 4pp PL-share growth from 2019 and Poland an 8pp increase.

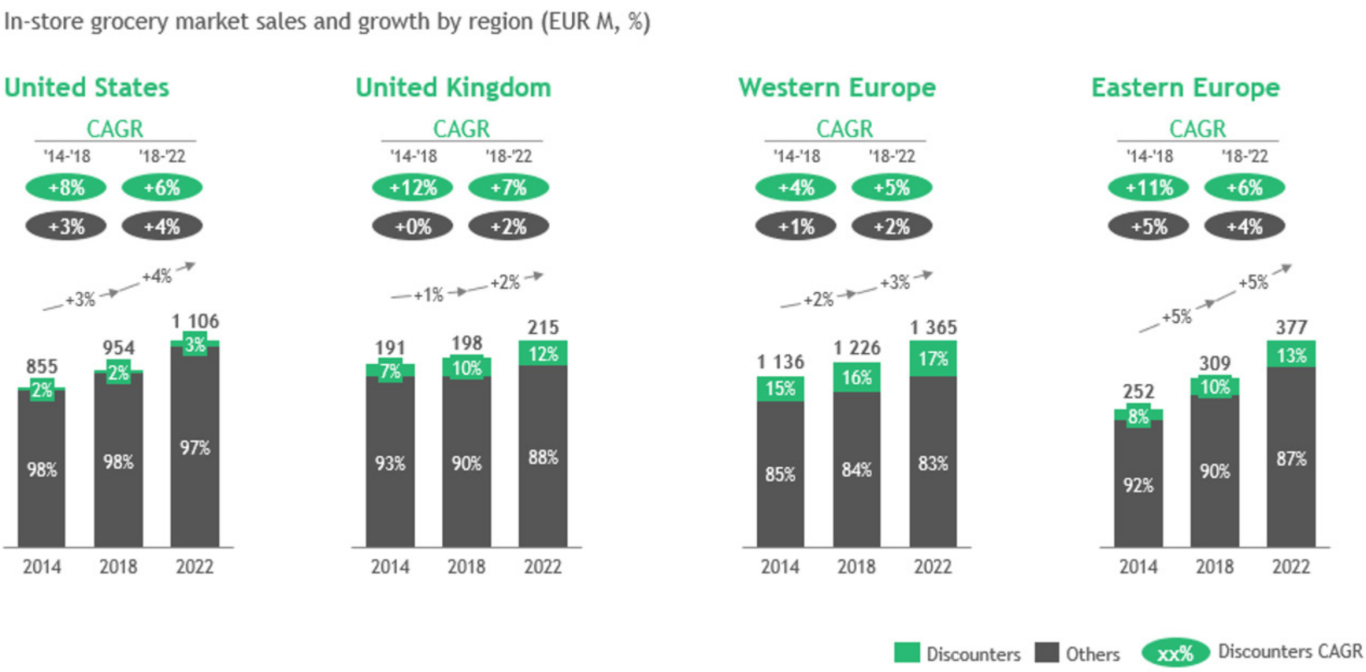
Indeed, consumers are changing not only what they buy, but how they shop. To hunt for discounts, they enroll in loyalty programs; to reduce unit costs and minimize the number of store visits (and thus save on gas), they buy in bulk; and to find cheaper alternatives on essential buys, they shop more at discount grocers (in BCG’s survey, discount channels saw a 42% net increase in expected shopping being done at discounters in the 6 months following the time of responses).

Exhibit 4 – consumers are reacting to higher prices by buying less and more cheaply, changing habits surrounding where and how they go shopping

1. BCG Recessionary behavior Consumer Sentiment Survey, Aug 2022 (US n=2,041; UK n=2,146; FR n=2,571; DE n= 2,504; unweighted)
2. Mintel consumer surveys, October 2022; UK n=2000; IE n=500; IT, PL, ES, FR n=1000
Source: Mintel; WSJ; Statista; Press search; Nielsen IQ; BCG analysis; Gartner

The increase of interest in grocery discounters plays into a longer-term trend in the US and Europe: the channel's revenue CAGR from 2018 has been 5-6%, 2-3pp higher vs. rest of the market, and 7% CAGR in UK, 5pp faster than the market (exhibit 5).

Exhibit 5 – discounters outgrew other channels by 2-5pp CAGR in the last 5 years as consumers move to cheaper alternatives



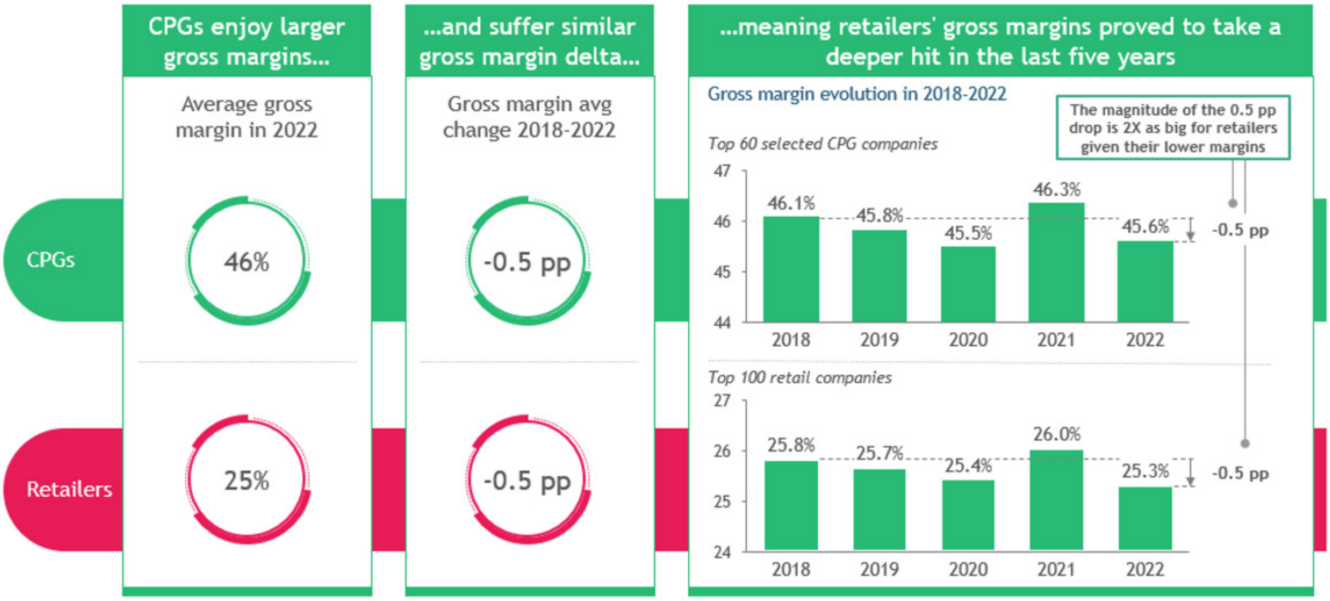
Note: 2022 totals forecasted; scales differ

Source: Euromonitor

Retailer and CPG margins suffering

Retailers and CPGs have experienced much volatility in the last few years. When the pandemic disrupted consumer life and constrained supply chains, they worked together to keep products on shelves. As inflation ramped up and created a new environment of volatility, margins for both retailers and CPGs were compressed. With this being said, retailers typically operate on thinner gross margins than CPGs do, so this margin compression has had a relatively more severe impact on retailers. Indeed, a comparison of top US retail companies and top relevant CPGs between 2018 and 2022 shows that, while both groups saw about 0.5 pp gross margin decrease during that time period, this decrease is doubly significant for retail given their gross margins are about half that of CPG to begin with (see exhibit 6).

Exhibit 6 – both CPGs and retailers have seen significant gross margin impact due to inflation, with retailers taking a heavier hit



Note: Retail companies selected are US only; Aggregated Gross margin values based on weighted average of sampled companies
Source: Financial filing data; BCG analysis

Exhibit 7 – retailers need to proactively face the challenge ahead, and develop a clear plan to mitigate this major risk to the P&L and competitive positioning

Beyond gross margin alone, inflationary pressures can affect all lines of a retail P&L to drive down profitability.

Illustrative P&L for a traditional retailer

Model income statement	Status Quo	"Do nothing" scenario	Change	Commentary
Revenue	1000	1020	+2%	Inflated prices offset lower volumes for moderate revenue increase
COGS	750	810	+8%	While suppliers have increased their prices substantially
Gross profit	**250**	**210**	**-16%**	**This leads to a higher COGS/income ratio and a dip in gross profit %**
Gross profit / revenue	***25%***	***21%***	***-4pp***	
Labor	100	108	+8%	Labor cost increases
Rent and utilities	20	22	+10%	Energy prices drive up rent and utilities bills
Other costs of sales	10	11	+10%	Other expenses continue to rise as a direct or indirect result of inflation
Admin expenses	10	11	+10%	
Taxes, D&A, other	50	53	+6%	
Total other costs	**190**	**205**	**+8%**	This drives up other costs of doing business
Total other costs / revenue	***19%***	***20%***	***+1pp***	
Operating profit	**60**	**5**	**-93%**	**And causes a steep decrease in profits**
Operating profit / revenue	***6%***	***0.5%***	***-5.5pp***	

Some are already taking action. For instance, Kroger is verifying prices of commodities and packaging costs, to make sure price hikes are tied to verifiable changes in inputs. In the UK, Asda recently expanded its relaunched its "Smart Price" line as an expansion of its "Just Essentials" own brand, giving customers more value options as branded prices rise.[3]

Source[3]: The Wall Street Journal, Retail Gazette

Reacting and Adapting to the New Environment

Given the extreme inflationary and competitive pressures, it's no surprise that retailers must react and adapt to today's shifting financial conditions and consumer behaviors. Several actions will be particularly important:

Sourcing and supplier management.
COVID-related supply shortages and rapid inflation have scrambled retailers' cost bases and thus the relative profitability of various brands and SKUs, and they need to be bold about bringing their costs back in line with current conditions. They should rigorously reassess relative costs and margins and address any areas where profitability is below par—and they should do so quickly, as competitors will be doing the same. Walmart and Whole Foods in the US and Tesco in Europe, to name just a few, have made headlines for pushing back on supplier price increases and revisiting assortment decisions when costs were out of line.

Retailers should be especially proactive in categories that have a direct dependence on commodities such as oils, coffee, meats, and dairy. These areas are likely to have seen sizeable increases as commodity prices rose, and retailers must ensure they are capturing the benefit of subsequent price declines. Tools that provide real-time tracking of commodity prices can help give them visibility into where these input-price decreases should be coming through. BCG's Commodity AI tool, for example, can break down products into their input commodities, assign weights to these commodities based on their relative contribution to product cost, and match these weights with real-time commodity prices to calculate "should cost" based on movements in the price of any input. This capability is supported by a workflow that generates proactive alerts for opportunities based on input cost declines.

Close scrutiny of the product assortment.
In tandem with reassessing costs and pricing, retailers should scrutinize their assortment mix closely to confirm that they have the right spread of price points, have maintained coverage of all customer segments and needs, and have considered all opportunities to build a richer mix of products.

In particular, retailers should ensure that their assortment contains a robust private-label offering, given the growth in that segment, and consider how to leverage private label to generate extra value for customers: for example, Waitrose, a British supermarket chain, recently announced price decreases for hundreds of items in its Essentials private label brand.

Lastly, retailers can capitalize on the lessons learned from their experiences with COVID and inflation. For example, did the lack of a given brand really hurt category sales? How did buying patterns shift when certain SKUs were unavailable? These unintentional experiments can provide key learnings to use in today's assortment decisions.

Improved pricing and pass-through decisions.
As consumers become more price-sensitive, retailers should account for demand elasticity in all their pricing decisions, especially when deciding whether and how to pass through cost increases—and when to absorb them.

Further, in most cases a full-line pricing review will be warranted, given the rate and urgency with which repricing decisions have had to be made over the last several years. Comprehensive, customer-centric, and AI-driven tools, such as BCG's Value Compass, help retailers optimize prices at the SKU, channel and store levels. Incorporating customer preferences and willingness to pay into pricing decisions enables retailers to invest where it matters and improve value perception. Simultaneously, leveraging AI allows them to optimize millions of pricing decisions at scale, simulate a variety of scenarios, and adjust prices dynamically.

Customer-first communications.
All of these actions will create opportunities to gain consumer trust. Retailers are increasingly communicating to customers the steps they are taking to mitigate impact, e.g., by giving them transparency on efforts to hold the line on price. This is part of a value-driven rather than price-driven message and can improve buyer trust and loyalty when done effectively.

Establishing a Long-Term Edge

Retailers should assume that every competitor will be looking into the same tools and initiatives; thus, the speed of action can be just as important as the tactics themselves. The stakes are high, given consumers' increasing willingness to trade down and shop elsewhere: the winners of the retail cost game in the next 12 to 18 months will have the foundation and resilience to win over the next 5 to 10 years.

About the Authors

Jamie Brindley is a Managing Director and Partner based in Prague, leads BCG's business in the Czech Republic and Slovakia. Jamie is a core member of BCG's Consumer practice, focusing in particular on supporting retailers. He specializes in category management and commercial strategy projects for his retail clients. Jamie has led projects across Europe, Africa, the Middle East and Australia.

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