GMA/FPA Executive Conference

Competing in the New World of Brands:

The Next Wave of Private Label

McKinsey&Company

GMA The Association of Food, Beverage and Consumer Products Companies

FPA Food Products Association

GMA/FPA

The Grocery Manufacturers/Food Products Association (GMA/FPA) represents the world's leading food, beverage and consumer products companies. The association promotes sound public policy, champions initiatives that increase productivity and growth and helps to protect the safety and security of the food supply through scientific excellence. The GMA/FPA board of directors is comprised of fifty-two chief executive officers from the Association's member companies. The $2.1 trillion food, beverage and consumer packaged goods industry employs 14 million workers, and contributes over $1 trillion in added value to the nation's economy.

McKINSEY & COMPANY

McKinsey & Company is a management consulting firm that helps many of the world's leading corporations and organizations address their strategic challenges, from reorganizing for long-term growth to improving business performance and maximizing revenue. With consultants deployed in more than 40 countries across the globe, McKinsey advises companies on strategic, operational, organizational and technological issues. For eight decades, the firm's primary objective has been to serve as an organization's most trusted external advisor on critical issues facing senior management.

Private label or store brands have been embraced by retailers all over the world as a key differentiator in an effort to win and retain consumers. While U.S. growth of private label has remained relatively flat over the last 15 years, the status quo appears to be changing. A maturing marketplace, increasing channel shift, successful foreign competitors entering the U.S. marketplace, and retailers challenged to find new ways to attract and retain their consumers increase the likelihood of growth in private label.

It is becoming clear that private label is no longer a price-centric strategy. Simply put, private label is changing the way retailers and CPG manufacturers view, approach and develop category management and promotion strategies. Understanding how customers/retailers are using and will use this tool in their go-to-market strategies is essential to the future success of today's CPG companies.

Identified as a key issue of the GMA/FPA Sales Committee and sanctioned by the GMA Industry Affairs Council in 2006, the GMA/FPA partnered with McKinsey & Company to take the lead in answering three key questions regarding private label:

- **How is the landscape of brands and private label changing as retailers build private label capabilities?**
- **Have/will changes in retailer capabilities affect consumer perceptions and behaviors?**
- **How can/should different manufacturers play in the new world of private label and how does this approach differ based on market position?**

Competing in the New World of Brands represents the latest installment in the Sales Committee's ongoing efforts to identify, explore and provide informative tools in the areas of industry-wide emerging retail expectations so that GMA/FPA member companies can better position themselves for success in the marketplace.

Grant LaMontagne
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Competing in the New World of Brands:

THE NEXT WAVE OF PRIVATE LABEL

Media attention on private label has doubled in the past five years, making it one of the most talked about issues in the grocery industry. Major retailers have launched new brands, entered new categories, and publicly stated their intent to make private label a core part of their strategies. In interviews, many retailers claim that private label is one of their top strategic priorities; several suggest that they plan to double their private label share in the next 10 years.

By all indications, private label products should be taking over the shelf and flying out of the store. Yet the activity and attention have not translated into real change: over the last 15 years, U.S. private label dollar share has remained flat, increasing by a mere 0.6 percentage points.

While recent history suggests that projected private label dollar share will remain relatively flat, retailers display a heightened interest in building more sophisticated private label programs and leveraging private label as a key growth driver. The difference between continued flat growth and an accelerated growth rate could translate into a shift of up to $55 billion over the next 10 years. Thus, there is a tremendous amount of "value at stake"– value that could potentially shift from traditional branded manufacturers to retailers. Such a shift could change the dynamics of the industry, with important implications for retailers, manufacturers, and consumers. Retailers and manufacturers together will determine whether private label will drive profitable growth or will destroy industry value.

METHODOLOGY

McKinsey & Company worked in partnership with the Grocery Manufacturers Association/Food Products Association (GMA/FPA) to develop a perspective on the current and future dynamics of private label; the team:

- Analyzed a comprehensive data set covering the more than 300 food and non-food categories reported by IRI and The Nielsen Company
- Studied the private label capabilities and performance of more than 70 retailers, including Costco Wholesale Corp., and Wal-Mart Stores, Inc.
- Interviewed several leading retailers and manufacturers – both branded and private label

In addition, the team relied heavily on the judgment and experience of our partners in this effort, including:

METHODOLOGY (CONTINUED)

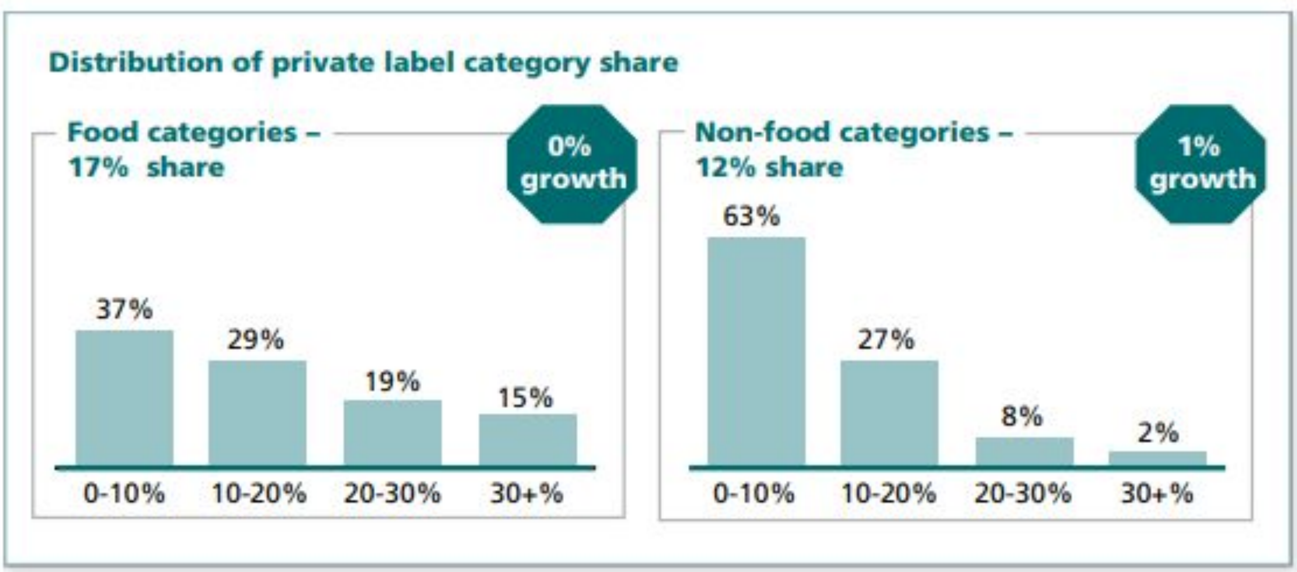
- Brian Barren, The Procter & Gamble Company
- Brian King, Acosta Inc.
- Grant LaMontagne, The Clorox Company
- Stephen Sibert, GMA/FPA
- Mark Wilhite, General Mills, Inc.

Taken together, these multiple sources of insight have provided a fresh, data-driven look at the trends that could lead to the "next wave" of private label growth, and implications for both retailers and manufacturers.

PRIVATE LABEL TODAY

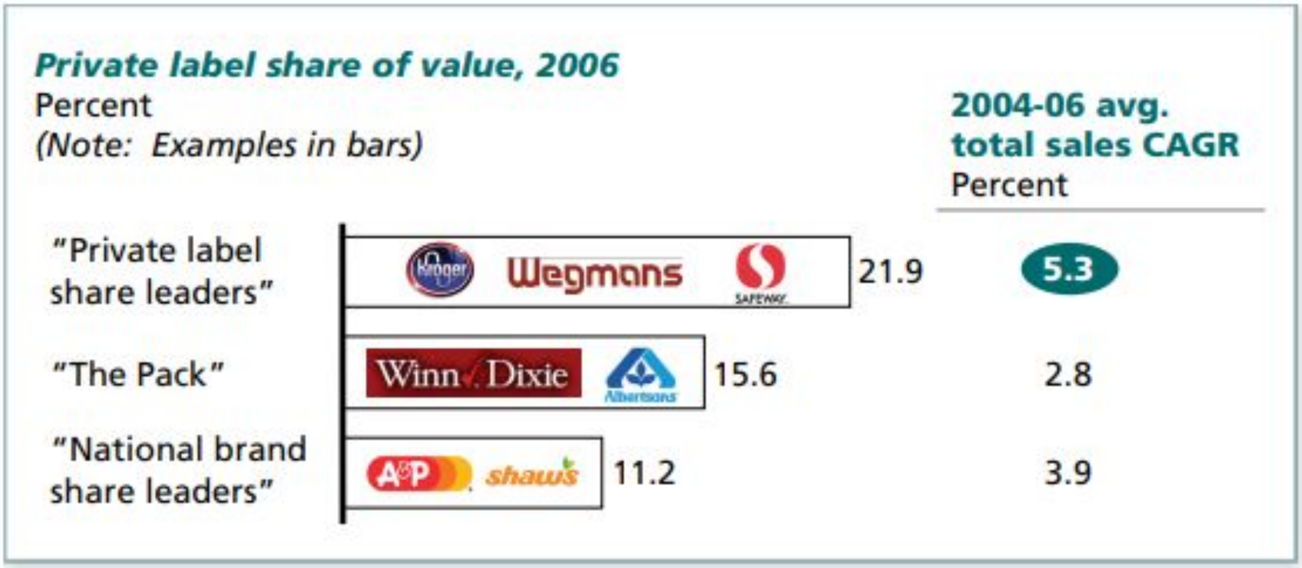
Private label dollar share has been flat across food and non-food categories and shows no sign of growth.

When we dive into the most recent industry data, the flat growth story holds across food and non-food categories on both volume share and dollar share. In fact, branded manufacturers have been winning back share in many of the traditional private label strongholds – categories including frozen vegetables and vitamins. There are some differences between food and non-food categories, however, with food showing overall higher dollar share (17 percent for food versus 12 percent in non-food) and somewhat lower growth (0 percent versus 1 percent) over the past three years. Despite attention and interest, the private label movement has not taken off in the US, and private label dollar share remains substantially lower than in Europe and Canada, where overall private label dollar share has reached nearly 30 percent in certain markets (e.g., Germany is currently measured at 32 percent).



A select group of retailers is driving dollar share levels much higher than the average, using private label as a point of differentiation.

While overall private label share is flat, there is substantial variation among retailers. A select group of retailers is driving higher levels of dollar share than the rest of the industry. These "private label share leaders" – including The Kroger Company, Safeway, Inc., and Wegman's Food Markets, Inc. – have achieved a 22 percent private label dollar share on average. Many of these share leaders have successfully used private label as a key differentiator and to build consumer loyalty. In addition, these "share leaders" have experienced higher levels of overall growth versus non-leaders (5.3 percent versus 3.4 percent over the past 3 years).



The bulk of retailers sits well below these leaders, with a 15.6 percent dollar share in private label. In addition, there remains a set of retailers that has remained focused on national brands; among these retailers, total private label dollar share barely exceeds 10 percent.

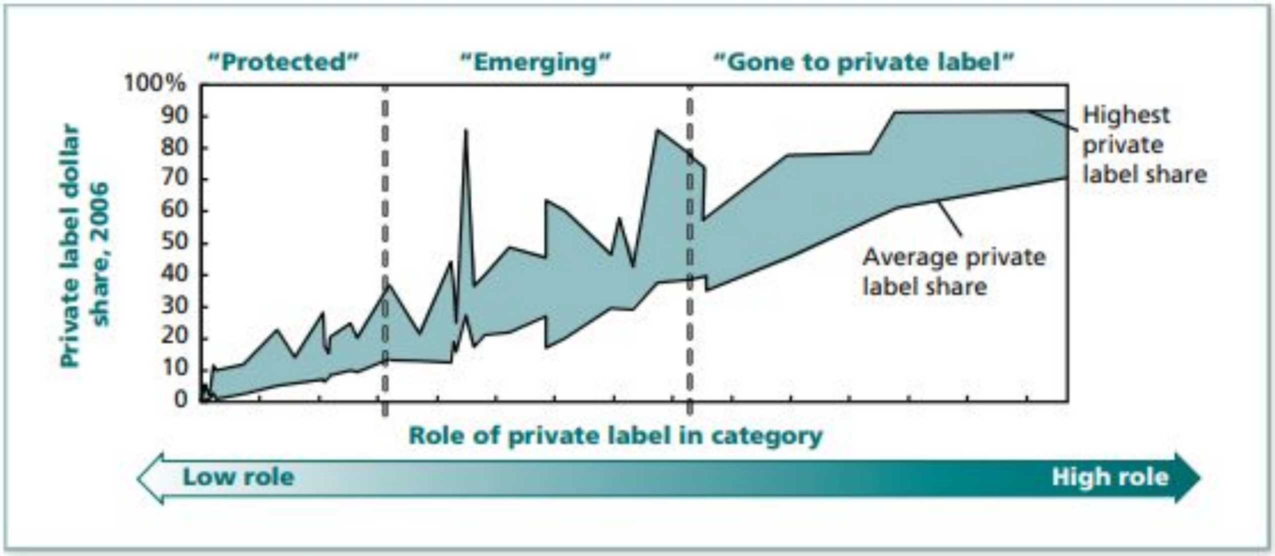
Private label dollar share by category is predictable, based on category dynamics.

Manufacturer- and consumer-based factors are key drivers in the role private label plays in each category. Private label dollar share is likely to be low in categories where, for example, (1) manufacturers' brand concentration, brand marketing, and pace of innovation are high, and (2) customers' emotional attachment to branded products and perceived risk of switching are great.

A third factor is increasingly important. More and more, retailer strategies and capabilities are driving the evolution of private label. Retailers that are using private label as a major point of differentiation with consumers – or have identified ways to price and source private label better than their competitors – are driving higher than average share and define the leading edge of private label development.

Select retailers have been able to drive dollar share well above what category dynamics would suggest, even in categories that have traditionally had low private label share.

Select retailers have driven much higher than average private label dollar share, even in categories that once were thought to be strictly brand territory. For example, in spaghetti sauce, industry average private label dollar share is around 5 percent, based on category dynamics and the strength of manufacturer brands like Ragu and Prego. Yet Wegman's has made this category a priority, driving private label dollar share beyond 20 percent, over four times the industry average. Similarly, in natural cheese, a category with higher overall private label dollar share (40 percent), strong private label retailers like The Kroger Co. including Dillon Companies, Inc. have driven up dollar share to 65 to 75 percent. High differentials in retailer performance can be found across nearly all categories.



This difference between industry average private label share and best-in-class in a given category represents the "value at stake." If individual retailers are able to drive these levels of private label dollar share, remaining retailers may eventually follow suit.

THE NEXT WAVE

"Value at stake" suggests potential for considerable shifts in private label share.

The existence of this "value at stake" does not necessarily imply that the industry average will ever reach the highest levels of dollar share, or even accelerate in that direction. Retailers have different strategies for private label, and different economic thresholds for what "optimal" share levels might be.

This gap does, however, imply the possibility of a shift, as retailers who currently find themselves with lower-than-average private label dollar share look to replicate the strategy of other retailers using private label to drive growth. Retailers continue to look for ways to differentiate their brand, build consumer loyalty, and improve overall economics. If best-practice retailers in the U.S develop private label programs that deliver these benefits, as we have seen from retailers such as Tesco PLC in Europe or Loblaw Companies Limited in Canada, other retailers will likely follow.

Based on current trends and the leading indicators of change – such as the actual performance of today's private label share leaders and stated private label growth objectives of several others – we have identified a range of potential outcomes for private label dollar share over the next 10 years.

Base case: Current trends continue and dollar share remains flat.

The base case scenario assumes that current trends, at both the retailer and category level, will continue. Retailers that have been winning share and expanding private label will continue to do so at their current pace, and retailers that have yet to expand their private label business will maintain that strategy.

Not surprisingly, dollar share remains largely unchanged under this scenario. By 2016, private label dollar share in the U.S. would increase only marginally to about 16 percent.

We believe that the following conditions would lead to this scenario:

- Retailers are at an equilibrium point in terms of private label share, and do not feel economic or strategic pressure to increase the role of private label in key categories;
- Manufacturers are able to provide a stronger value proposition for both consumers and retailers than can be achieved through private label offers; and
- No external shocks occur that could drive the industry further toward value.

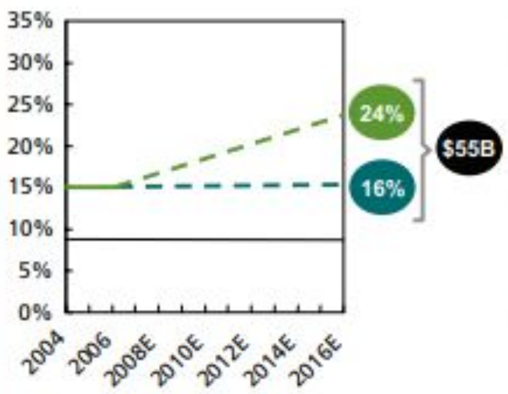
Aggressive scenario: Retailers build private label offerings and drive dollar share higher.

If retailers do go after the value at stake, a more aggressive private label scenario is possible. We estimate that private label could reach up to a 24 percent dollar share by 2016. This seismic shift would require a number of meaningful changes to the industry including:

- Private label continues to play heavily into successful growth strategies for Target Corp. and Costco Wholesale Corp.;
- WalMart Stores, Inc. places a greater emphasis on private label than they have historically;
- Leading grocery retailers (such as The Kroger Co. and Safeway, Inc.) continue to expand both the categories in which they offer private label and the dollar share within those categories due to attractive economics and ability to differentiate;

- These results plus competition from new entrants drive remaining grocery retailers to pursue private label aggressively, and;
- Consumers increasingly embrace private label or store brands. (Note: 77 percent of respondents agreed wth the statement "private label brands are a good alternative to other brands" in a 2005 AC Nielsen survey.)

Projected private label dollar share
Percent



Base growth scenario

- We are at an equilibrium point in terms of private label share, and current retailer and category trends continue
- Manufacturers are able to provide a stronger value proposition for both consumers and retailers
- No external shocks occur that could drive the industry further to value

Aggressive growth scenario

- Target and Costco continue to grow private label aggressively, and Wal-Mart increases private label focus
- Additional leading grocery retailers expand private label offer, driving remaining grocery retailers to pursue aggressively
- Consumers embrace private label brands, in step with retailer offerings

The aggressive scenario is possible: assumptions are consistent with the European experience and stated U.S. retailer projections.

The intent of this projection is to describe the upward bound of private label growth over the next decade. While this scenario is aggressive, it is within the realm of possibility. In the 1990s, as many European retailers began to understand the impact that private label could have on their business, private label share more than doubled in several major markets. Tesco PLC has expanded its private label offerings in Europe, increasing share by 3 percentage points annually (from 21 percent to 34 percent over 4 years). In our interviews – and in public statements – current share leaders and private label "up and comers" have shared the aspiration to reach dollar share levels and growth consistent with the European leaders.

RETAILERS' PRIVATE LABEL CAPABILITIES AND ACTIONS WILL SHAPE INDUSTRY LANDSCAPE

Regardless of the pace of evolution, private label is here to stay. Important retail brands, like Kirkland Signature and Ol' Roy, have become well-established consumer brands, and possess brand equity as strong as or stronger than some manufacturer brands. Retailers such as Trader Joe's Company and Whole Foods Market, Inc. have established distinctive positioning built around private label. Going forward, private label will continue to be one of retailers' best opportunities to differentiate themselves from competition and build consumer loyalty.

While private label can be a key element of grocery retailers' strategies, it is not always easy to execute. For many U.S. retailers, the economics of private label have historically been equal to or only slightly better than those of branded products, particularly on a penny-profit basis. That said, there is evidence that a well-designed and well-executed private label program can enhance retailer margins. Retailers need to address product assortment, pricing, and sourcing challenges to ensure attractive economics.

Retailers who want to compete in private label will have to "raise their game."

Leading private label share players – across Europe, Canada and the U.S. – have all developed a set of capabilities to address the unique challenges and opportunities that private label presents. Retailers can and should learn from these examples as they build out their own private label programs.

In reviewing the private label success of share leaders, we identified five key capabilities that private label share leaders demonstrate:

- **Pursue proprietary shopper and consumer insights to differentiate stores and brands**: While consumer insight was once believed to be the domain of the manufacturers, retailers are increasingly using the connection they make in the store to better understand their consumers.
- **Identify categories and products where private label could address unmet consumer needs, using innovative products to capture category white-space**: Better understanding of consumers leads to better category management. Leading private label share retailers are taking a holistic view of categories to create the right roles for both manufacturer brands and private label to drive overall profitability.
- **Take a holistic view of category economics to grow category profits**: With the right assortment in place, best-practice retailers price to drive volume to highest margin products among both manufacturer brands and private label. Taking a holistic view of category pricing enables overall margin optimization.
- **Develop marketing and merchandising capabilities, creating cross-category brands, and going beyond winning with price**: Private label share leaders are leveraging inherent advantages in marketing their own brands. They have a greater degree of control over the messages at the shelf and the ability to build meaningful brands that cross categories.
- **Organize for success – not just sourcing, but right strategies, business plans and incentives to drive overall profitable growth**: Retailers that are committed to win are enhancing their merchandising organizations and adding capabilities like shopper insights and marketing that used to be exclusive capabilities for manufacturers. They are also improving their sourcing capabilities with global pursuit of lower cost and more unique products.

STRATEGIES FOR MANUFACTURERS TO PLAY IN THE NEXT WAVE OF PRIVATE LABEL

Clearly, an industry shift as dramatic as the aggressive scenario describes would have important implications for manufacturers. While the future will largely be driven by how quickly retailers build capabilities, manufacturers' actions will have a significant impact as well. Manufacturers will need to strengthen a core set of capabilities, while developing category specific strategies that are informed by the role private label plays in the category, the strength of their retailer relationships, and their position in their categories.

The impact of private label will vary significantly by category and retailer.

Private label plays different roles across categories. In some cases, private label growth has helped to drive overall profitability, and both retailers and manufacturers have benefited from the rising tide. In other cases, aggressive private label growth has come at the expense of manufacturer brands. Private label growth can have positive or negative effects, depending on the actions of retailers and manufacturers.

In the past, leading brands in categories where private label share has historically been low may have believed that private label did not have a role to play, and therefore did not merit focus. However, our research shows that individual retailers have driven growth in private label across all categories, including ones in which private label has not traditionally been as significant. For example, in snacks, Target Corp. has been able to drive private label share of 12 percent, compared to industry average of six percent. Importantly, Target Corp. appears to have driven private label growth in snacks by targeting "white space" flavors and other items not in branded manufacturer portfolios.

Private label growth often comes at the expense of second and third-tier brands, but this is not always the case. We have seen examples of private label growth 'sourced' directly from brand leaders, particularly in mass channels where carrying a full assortment remains a retailer priority. It is clear that all manufacturers must think through implications of private label for their brands and categories.

Manufacturers need a core set of capabilities for the new world of private label.

Given the value at stake in private label, five capabilities are increasingly important for manufacturers:

- **Develop deep consumer and shopper insights**, and the ability to combine the insight with retailers' behavioral, shopper-based insights, to create powerful category growth strategies. Manufacturers who view the rise of private label as only a threat will soon find themselves at odds with their retail partners. Winning manufacturers understand that this shift is underway, and are building greater insights to earn the right to partner with retailers to better understand and deliver against consumer needs, growing categories together.

- **Increase the pace and quality of technologically- and commercially-driven innovation to differentiate brands and create category value**: Innovation has always been a key to ensuring that brands have a vibrant role in growing categories profitably. Innovation will be even more important in the world of higher private label presence, as retailers begin to use innovation of their own to drive private label. For example, The Dannon Company, Inc. established a new sub-category: DanActive probiotic yogurt. The Kroger Co. quickly developed its own product to compete with DanActive. In addition to technological innovation, winning manufacturers will take a leading role in commercial innovation – building unique offerings for the retailer and becoming invaluable to retailers for the role they play in differentiating a retailer's brand.

- **Build stronger in-store marketing and merchandising capabilities to connect with consumers at the point of sale**: With the proliferation of consumer segments and needs in a fragmenting media environment, communicating with consumers is increasingly difficult. Insight on where and how consumers are making brand choices, and the most effective ways to influence that choice, will help determine where manufacturers invest their marketing dollars. Winning manufacturers will likely have the in-store experience play an ever larger role in helping them build their brands.

- **Redefine brand differentiation in context of biggest retailers building stronger cross-category/umbrella brands**: Manufacturers understand that retailers are using their stores and marketing to build more powerful, "umbrella" brands across categories. As retailers build these strong brands of their own, manufacturers will need to add private label to their competitive set. Manufacturers should also re-think their unique points of difference and how to build powerful emotional connections to their consumers, taking advantage of unique and "own-able" brand equity.

- **Actively develop differentiated solutions to meet different retailers' needs:** The evolution of private label will not occur at the same pace at the account level, or across categories. Winning manufacturers will tailor their propositions for retailers who are expanding the role of private label, versus those who choose to have it be less significant. These differentiated solutions may vary at the overall account level, and even at the store level, as winning manufacturers understand which solutions work best for their retail partners' shopper segments.

Manufacturer strategies will vary significantly by category, depending on three factors.

With these stronger capabilities, manufacturers will need to consider three core factors as they develop their category strategies:

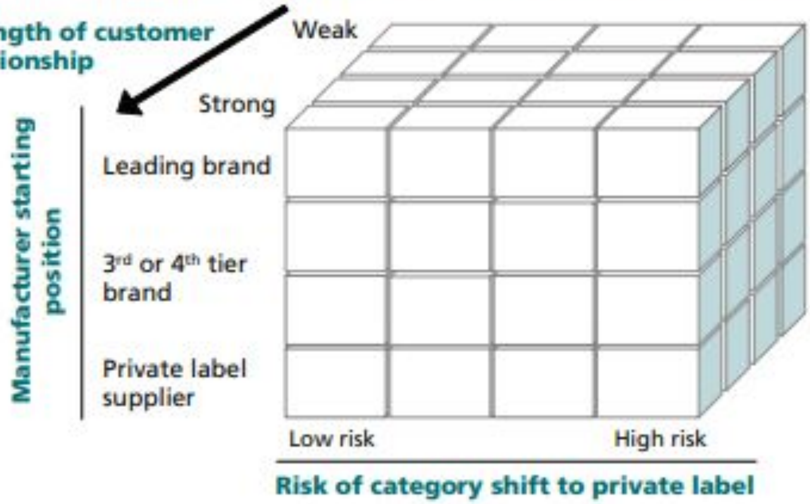
- **The role of private label**: Manufacturers need to understand the core drivers (as described earlier) which determine the role private label will play category by category

- **Their starting position**: Optimal manufacturer strategies' will vary based on their position within the category, both in terms of their brand strength, as well as their competitive position given the microeconomics of the category (e.g., relative cost position, distribution economics)

- **Strength of retailer relationship**: The strength of the retailer relationship is an additional key factor, as it will have an impact on how manufacturers can play in the category, and will guide the nature of collaboration

These three dimensions are represented in the cube below. Each box represents a different starting position a manufacturer may have in a given category and at a specific retailer.

The three dimensions that define a manufacturer's starting position



These three dimensions will enable a manufacturer to develop powerful category strategies both across and within their key accounts. There is no one-size-fits-all solution to growing as private label evolves. Strategies will range from focusing on their own brands to pursuing both branded and private label growth, with numerous variations in between. Below are two example strategies, driven by specific manufacturer starting positions:

- **Low role of private label, high brand share, and strong retailer relationship**: In categories where private label plays a less active role, and where they have a strong relationship with retailers, leading manufacturers might pursue a brand-focused strategy. This would include helping retailers differentiate by creating customized branded products, through tailored offerings such as flavors, pack sizes, or promotions. It may also include re-examining industry capacity and cost position to ensure continued ability to deliver healthy margins for retailers and manufacturers alike.

- **High role of private label, moderate brand strength, and a variety of retailer relationships**: At the other end of the spectrum, in categories where private label plays a strong role, and where manufacturers have a third or fourth tier starting position, manufacturers may consider playing a more active role in private label. As retailers seek to expand their private label offerings, they will be looking for strategic suppliers. Manufacturers should consider the growth, profit and strategic implications of private label supply. In addition, there have been several examples of smaller brands becoming captive retail brands. Typically, these are good brands that have experienced market share erosion to the point that it no longer makes sense for the manufacturer to support them with broad marketing efforts across channels.

In addition to category-specific strategies, manufacturers should consider a set of actions across their brand and category portfolios including the following:

- **Focus on categories with lower potential for private label, and consider de-emphasizing or divesting others**: While the predictability of private label share by retailer has lessened recently, overall private label penetration remains reasonably predictable. Manufacturers should look hard at the evolution of private label across their categories to understand how it will affect the microeconomics and category structure of each. Manufacturers may benefit from divesting and/or de-emphasizing some categories while investing disproportionately in others where their own brands can deliver unique value to consumers.
- **Review the overall product portfolio to identify opportunities to plug gaps in a good-better-best category structure – look hard for both premium and opening price point opportunities**: Often, retailers launch private label into categories to fill a price point gap. Manufacturers can add substantial value to the retailer by providing the appropriate array of price points for a category. Doing so creates several benefits to the retailer including streamlining the supply chain.
- **Re-evaluate their own underperforming brand portfolios as retailers will increasingly push to optimize overall category offer, and will be looking to manufacturers to help**: As retailers expand their private label offering, shelf space will become even scarcer. Retailers will be working to ensure that every product on the shelf fits a specific consumer need.

IN SUMMARY

While the future of private label remains uncertain, there is over $55 billion of "value at stake." Today, several large, high-performing retailers have begun to pursue a more aggressive private label strategy, hoping to differentiate their brand, drive consumer loyalty and generate increased returns. Tomorrow's leading manufacturers and retailers have an opportunity to actively prepare for and shape the outcome aimed at driving a win-win outcome for manufacturers, retailers and consumers alike.

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