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Navigating inflation in retail: Six actions for retailers

Retailers are facing the possibility of persistent inflation—but they can meet that challenge in ways that streamline operations, retain customers, and drive profitable growth.

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Inflation landed like a thud in the retail sector in May as industry leaders reported on the impact that higher costs were having on their operations. It wasn't long before investors responded, and some of America's largest retailers saw the biggest declines in their stock prices since the market crash of 1987.

Last year, as more and more Americans were vaccinated against COVID-19, retailers enjoyed a big boost in sales. But the strong demand for goods soon overwhelmed supply chains, and supply-demand imbalances combined with commodity-driven cost pressures to drive prices higher. In the US, inflation hit nearly 8.5 percent in March 2022, its highest level in 40 years.[1] Commodity prices jumped again when Russia invaded Ukraine, exacerbating cost increases, both direct and indirect, for retailers and sending inflation still higher.

Planners have come to expect an approximately 2 percent inflation rate, but it has become increasingly apparent that inflation could remain well above that through next year and possibly beyond. Central banks worldwide are raising interest rates to temper demand and limit future inflation, but those efforts will take time to yield results.

Retailers across the sector must reckon with the new realities of record inflation and develop solutions to sustain their businesses, retain customers, and ensure long-term growth. We've identified six key areas where industry leaders can focus their efforts to transform this period of stress into an opportunity for the future.

Retailers are getting squeezed

As the economy has opened back up in recent months, we've seen both top and bottom lines challenged with slowing sales growth for some and compressing margins—a challenging combination for retailers. Looking ahead, the industry is likely to face a more challenging growth environment even as it deals with increased expenses. Retailers must contend not just with the rising cost of merchandise, but also with cost increases on everything from manufacturing inputs to freight and fuel to wages. In addition, e-commerce now represents nearly 13 percent of all retail sales, placing further downward pressure on retailer profitability.[2]

While inflation hasn't had a meaningful impact on nominal consumer spending yet, we are beginning to see early signs of a potential pull-back. In the early months of 2022, amid record inflation, US consumers continued to open their wallets. The growth in consumer spending was perhaps not surprising: US consumers had approximately $3.3 trillion more in savings than they had in 2019, and many didn't hesitate to dip into those reserves as pandemic restrictions eased.[3] And it hasn't been just the savers making purchases; credit card debt is starting to rise as well.

While overall spending remained strong, consumer spending has eased in some categories that were previously growing, causing them to flatline or even drop. Much of the year-over-year growth in grocery spending is due to inflation, not greater consumption. In categories such as gasoline, travel, and restaurants, consumers are paying more but consuming less.[4]

As another indicator of a potential slow down, we saw consumer sentiment begin to dip in late February, when consumers began adopting more value-conscious behaviors. Only 38 percent of respondents to McKinsey's latest Consumer Pulse survey said they felt optimistic, down from 44 percent in October 2021.[5] The steepest drop in sentiment was among higher-income consumers, who frequently traded up to more expensive products and brands in 2020 and 2021 but might soon rein in spending. With COVID-19 stimulus money dried up and inflation impacting day-to-day purchasing, lower-income households remain the most pessimistic about the state of the economy.

[1] U.S. Bureau of Labor Statistics, "Consumer prices up 8.5 percent for year ended March 2022," April 18, 2022.
[2] U.S. Census Bureau, NBER, McKinsey analysis.
[3] Bureau of Economic Analysis, Federal Reserve Board, NBER, McKinsey analysis
[4] Kari Alldredge, Tamara Charm, Eric Falardeau, and Kelsey Robinson, "How US consumers are feeling, shopping, and spending—and what it means for companies," McKinsey & Company, May 4, 2022.
[5] *Ibid.*

These shifts in sentiment are beginning to play out in shopping behavior, with more US consumers reporting that they switched brands and retailers in 2022 than at any time since the pandemic began. And most of them say they intend to keep switching, with price at the top of the list of consumer motivations. With inflation at a record high, more people are looking for value; among those who said they've switched brands, slightly more than a third said they opted to buy private-brand products.

Almost all consumers—90 percent—have noticed that prices are going up. In particular, they've reported significant price hikes in two things that many people buy multiple times a week: gasoline and groceries, which could lead to a softening in spend for discretionary items should the trend persist.

We have also seen considerable concern about retail prospects from Wall Street. Of the 79 large retailers that reported earnings between April 1 and May 23 this year, 59 percent disclosed a decline in consensus revenue estimates for 2023, and 71 percent saw a decrease in estimates for 2023 earnings before interest, taxes, depreciation, and amortization.[6] Two-thirds of these companies saw their share prices decline on the day they reported earnings. Over the same period (April 1 to May 23), the S&P Retail Composite Index fell 24.1 percent—nearly twice the decline of the S&P 500 over the same period.

An opportunity to reposition for future growth

Retailers can catalyze these challenges into opportunities—*if* they make bold, deliberate decisions. Indeed, companies that achieve breakthrough performance during economic downturns tend to outperform their peers over the decade that follows. We saw this following the Great Recession of 2007 to 2009; the most resilient retailers were able to drive 11 percent annual growth in total return to shareholders, more than five-times higher than their peers through 2018.

While there is no silver bullet, retailers can take a number of transformative actions to address inflation and drive a step-change performance for the years ahead. Those that take a comprehensive approach will be able to combat inflationary pressures and preserve their profitable revenues. To that end, we've identified six areas of focus for retailers in the near term:

1. *Revisit their category strategies to reflect shifts in consumer purchase behavior and margin profiles.* In today's environment, consumers are becoming less brand-loyal and turning to private-brand goods to cope with inflation. To turn this to their advantage, retailers should regularly re-examine their category strategies. Winning retailers will balance rapidly shifting consumer preferences (perhaps in value categories) with product-specific inflation pressures. This may mean thinking differently about their mix of private and national brands. Those seeking to improve private-brand penetration can first develop brands with high awareness, advocacy, and stand-alone loyalty by adopting consumer-led brand strategies and category-management and design capabilities that consumer packaged goods companies are known for. Knowing which product categories face the most inflationary pressures and are likely to encounter meaningful changes in consumer behavior can help retailers make informed category-strategy decisions.

2. *Address end-to-end cost-to-serve through enhanced supply chain visibility and diversification.* Retailers can reorient their supply and distribution networks to route shipments through low-congestions ports and lower-cost ocean lanes, place distribution centers in optimal locations that balance labor availability or costs with last-mile costs, and use third-party logistics and supply-chain-as-a-service providers to reduce asset intensity and distribution overhead. Greater visibility of end-to-end inventory, fulfillment costs, and customer experience metrics can enable retailers to more effectively balance costs and services.

[6] Median Consensus Analyst Estimates, S&P Capital IQ.

3. *Go granular with pricing and promotion and tailor value delivery to consumers.* Instead of implementing broad price increases that may erode customer trust, retailers can tailor their inflationary price response by customer and product segment, considering both margin performance and consumers' willingness to pay. Raising prices is unpleasant for both consumers and retailers. Retailers that take a surgical approach are more likely to emerge with profitability and consumer relationships intact. Further, retailers can re-evaluate their price and promotion mix during this time; pulling back on promotions can help manage cost increases without raising prices.

4. *Use next-gen sourcing tools to drive sourcing excellence for private-brand and branded goods:*

— There is a wide range of maturity in private-brand sourcing. When retailers started sourcing private-brand goods, many simply replicated their branded-goods sourcing models. The most advanced retailers have evolved dramatically from those early days, realizing they have full control of the product design and specifications as well as the value chain, and negotiating based on cost. To do this, retailers can deploy next-gen sourcing tools to create real-time visibility into the impact of inflation on end-product costs and develop bottom-up product cost targets across their portfolios. Real-time cost-monitoring tools allow retailers to identify what the real impact of input cost changes should be—of raw materials, freight, labor, exchange rates, and so forth—and where those diverge from supplier-proposed prices and take action. Digital should-cost models enable retailers to quickly develop a detailed view of what their products should cost across thousands of SKUs and easily adjust them as market conditions evolve. They can then leverage these real-time insights to better manage their exposure to inflationary inputs by optimizing product design and specifications and reassessing their vendor-country matrix.

— For branded goods, retailers can investigate options for enhancing margins across their portfolio. First, they can increase transparency to understand "all-in" margins with vendors, incorporating all costs, funding, and value-add services to ensure that merchants fully understand the trade-offs between brands within their portfolio. Then they can deploy advanced analytics to better inform commercial decisions on things like shelf-space transferability and PLU investment rather than relying on intuition. This will help them understand the impact of macro-economic changes such as commodity prices and shipping on end-product costs. Finally, they can engage their vendors in a consistent and fact-based manner, supported by a central team, to ensure collaboration in navigating the challenges of an inflationary environment.

5. *Rethink store operations to optimize productivity.* To counter the effects of labor cost inflation, retailers can re-evaluate their in-store processes and look for opportunities to reset the store operating model by deploying technology and analytics, resetting labor allocation and scheduling, and taking an end-to-end view of costs. Retailers may also invest in frontline employee experience and retention to reduce costly turnover by leveraging recruitment and talent analytics and rethinking capability building.

6. *Set up an inflation "win room."* Managing the implications of inflation across a broad operational landscape calls for a cross-functional, disciplined, agile response. An inflation "win room," or a flexible, cross-functional structure with the authority to coordinate the inflation response can set clear goals for the organization, establish one source of truth, increase the speed of decision making, and ensure a systematic, fact-based approach to tracking execution, diagnosing wins and losses, and applying lessons learned.

The environment for retailers is likely to remain challenging for some time, but the situation also presents an opportunity for those that move decisively and quickly to develop a response. Most retail organizations have the capabilities required to weather the storm and emerge as a winner.

Recognizing that inflation is likely to persist can give retailers a solid incentive to act holistically across the organization and value chain. The future will belong to those willing to reshape their capabilities and grow their organizational resilience.

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