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Income inequality: an existential crisis in the consumer goods industry

Income inequality is not a new challenge for global markets. It is a crisis that has been building for years. The rise of social media has publicized the problem by casting the differences between the haves and have-nots into sharper relief than ever.

Many retailers and consumer products manufacturers have yet to confront how income inequality is fundamentally changing their industries. It threatens the very existence of consumer-focused companies by undermining the buying power of their core middle-class consumer base—forcing these companies to reorganize their business models around consumers in an increasingly fragmented market. The problem, moreover, is long-term, and will only grow in the coming years.

THE ELEPHANT IN THE ROOM

Income inequality is fundamentally a measure between the haves and the have-nots. It has always existed, but the financial crisis of 2007-2008 and subsequent transparency into credit availability focused more attention on it. As economist Branko Milanovic discussed in his book *Global Inequality: A New Approach for the Age of Globalization*, income inequality is a global phenomenon that has not seen such heights since the Industrial Revolution. One of his best-known charts, appropriately dubbed "The Elephant Curve," shows the change in real income between 1988, the entry of socialist economies, to 2008, the global crash, at various percentiles of global income distribution (figure 1). The chart's profound implication is that in most developed markets, and in many developing ones as well, the underlying factors all suggest a continuing increase in inequality. These problems are not only systemic, but will worsen over time.

The lower right section of the chart shows that during the last 20 to 30 years, consumers in the lower- to middle-classes in developed markets have seen

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virtually no increase in household incomes. This middle-class population can use social media to watch the elite buy luxury items, yet when they turn off their screens and look at their own lives, they see nothing but stagnation.

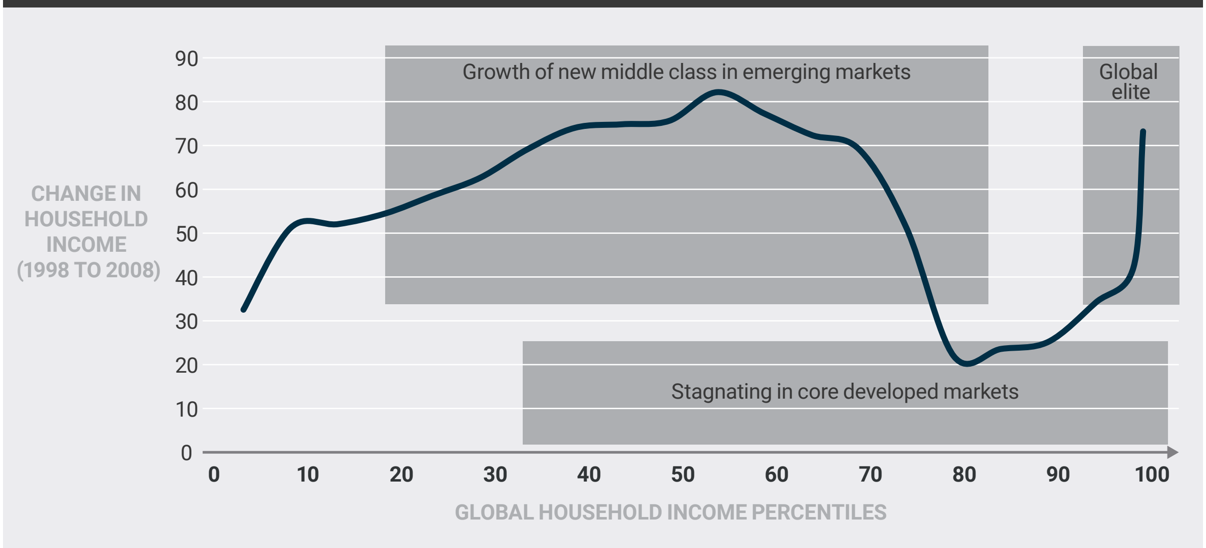
Focusing on consumers who are wealthy—and getting wealthier—might seem like an enticing opportunity for consumer goods companies. Yet the affluent cannot make up for the falling spending of the middle class. Because wealthier consumers tend to save more of their income, a smaller portion of their income gains translates into retail sales than middle-class income gains would.[1] What's more, the well-off also spend their discretionary income only partly on the types of products made by consumer businesses and more on experiences like travel and dining. The middle demographic, then, is the heart of the global consumer industry, and continues to be the key to its future.

The exact level of income inequality may be inconsistent across world markets, but it is an unavoidable feature of the modern world. When there is a sudden change, or shock to economics in a country, such as the 2008 financial crisis, this compels people to seek value options—opening the door to the discount model. Many mainstream retailers either didn't notice these drastic shifts in inequality, or they noticed but didn't respond in a timely manner. It's possible that they lacked sufficient data, or were too entrenched in their traditional business models to anticipate a surge in bargain seekers. Their loss became someone else's gain.

In the UK, for example, discount German grocers Lidl and Aldi successfully entered the market in the Thatcher years amid changes in labor and tax laws that drove up inequality (figure 2). Similarly, what drove their growth in Germany was the country's reunification in the 1990s, which also led to major income disparity.

Meanwhile, countries that have experienced relatively gradual increases in income inequality, like France

FIGURE 1: CHANGES IN GLOBAL INCOME DISTRIBUTION



Source: Branko Milanovic, *Global Inequality: A New Approach for the Age of Globalization,* 2016

[1] *"The Rich Can't Save Retail,"* Brendan V. Duke. March 12, 2015.

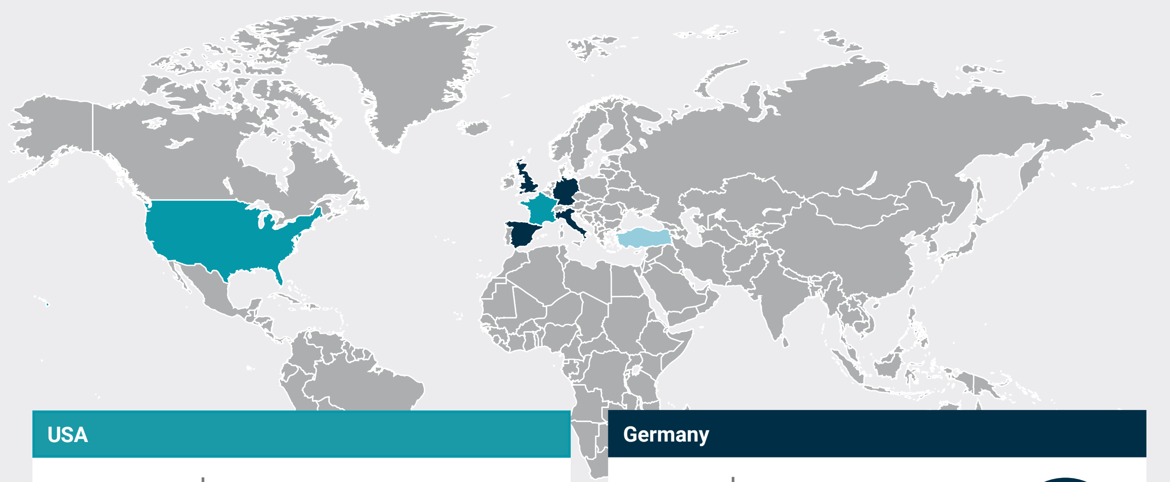
and the US, have not yet reached those tipping points where we would see a spike in shopping at discounters. However, if income inequality trends continue, it is likely they will. It's worth noting that discount retailers like Dollar Store and Aldi grew significantly during the 2008 recession. Growing numbers of consumers who might typically shop higher-end retailers have more frequently been shopping at discounters.

Income inequality is squeezing those in the middle with income rising slower than the goods and services they consume. As a result, those in the middle are likely to make more value-oriented choices to change stores, to buy less, or to switch to lower-priced products.[2] Clearly, consumer businesses need to adapt to these trends to stay competitive.

A FIELD STUDY: HOW RETAILERS STOCK SHELVES IN DIFFERENT INCOME ZONES

To take a deeper dive into what retailers are doing today to confront these challenges, we conducted an extensive field study in April 2017. We examined the private label SKU assortment decisions, that is, the

FIGURE 2: CHANGES IN INEQUALITY SHOCK CUSTOMERS INTO CHANGING BEHAVIOUR, DRIVING THE DISCOUNT MODEL



USA
Entry
Aldi 1976/1979
Lidl 2017
Increasing inequality since 1960s – but not steep increase, or change of direction
3.3%

Germany
Entry
Aldi 1961
Lidl 1973
Reunification drives growth
22.1%

UK
Entry
Aldi 1990
Lidl 1994
'Thatcher years', changes in labor laws, tax regime
7.7%

Turkey
Entry
BM 1995
Rising incomes and declining income inequality
41.1%

Spain
Entry
DIA 1979
Lidl 1994
Aldi 2002
Democracy
Inequality in decline, reversal in 1994
7.8%

Italy
Entry
Lidl 1992
MD Discount 1993
Eurospin 1994
Inequality in decline since 1900, reversal in 1994
13.6%

France
Entry
Aldi 1988
Lidl 1988
Relatively flat in inequality till mid 2008
6.3%

■ Economic shock to change behaviour
■ Steady movements, no shocks at a country level – yet
■ Discount model displacing traditional channels
% Share

Source: OECD data, AlixPartners analysis

[2] The Squeezed Middle Class in OECD and Emerging Markets, OECD.

percentage of assortment and facings versus branded goods that a range of retailers—including discounters, mainstream retailers, and convenience stores—made in different income zones. The aim was to understand how retailers adapt their offer by local economic conditions. We examined their assortments for ketchup across London (figure 3), cleaning products across Boston, dried pasta across Frankfurt, and potato chips across Mumbai.[3]

We found that almost none of these stores rigorously tailored their assortments around local economic conditions. Some retailers offered exactly the same range and mix for both high-income and low-income neighborhoods. Others offered a consistent range but only a slightly tailored mix for different income zones. Overall, we did not find a clear and consistent approach in London, Boston, or Mumbai. Strangely, some of the Frankfurt retailers offered a tailored but counterintuitive range and mix for pasta products. These Frankfurt stores are stocking their shelves with a high percentage of private label SKUs and facings for higher income consumers, and offering a far lower percentage for lower income consumers.[4] These retailers—and manufacturers as well—seem to be missing a golden opportunity. As economic shifts continue to squeeze lower and middle class consumers, these shoppers will increasingly turn to private label and discounters. Consumer businesses need to capture that opportunity. They should build a clear strategy around private label assortment that's grounded in a firm understanding of their consumers' spending habits in different neighborhoods.

Failure to address these real pressures on your customers will open up the way for someone who will tailor their offerings and take your customer base. Mainstream retailers have seen this with customers moving to discounters. Manufacturers and retailers will also face contradictory pressures for SKU rationalization to manage costs and SKU proliferation to address specific customer needs.

IMPLICATIONS FOR THE FUTURE

Surviving and thriving today requires focusing on a few critical elements across the value chain. The path forward is best understood as a four-part framework (figure 4).

Targeting precision

Targeting precision means using big data and finding the right data to get granular at the local level. Both retailers and manufacturers need to be laser focused on understanding their consumers. Where do their consumers live? What specific challenges do their customers face? Where are their own stores and where are their competitors' stores? They will need to study the communities around their stores and tailor their offerings to those markets. Manufacturers need to gain the same level of understanding about the specific stores that sell their products so they can drive conversations with retailers—and get ahead of the market.

Using big data to understand consumers is nothing new. But given the microeconomies and complexities

FIGURE 3: UK RETAILER PLANOGRAM VERSUS LOCAL ECONOMIC CONDITIONS (KETCHUP, LONDON)

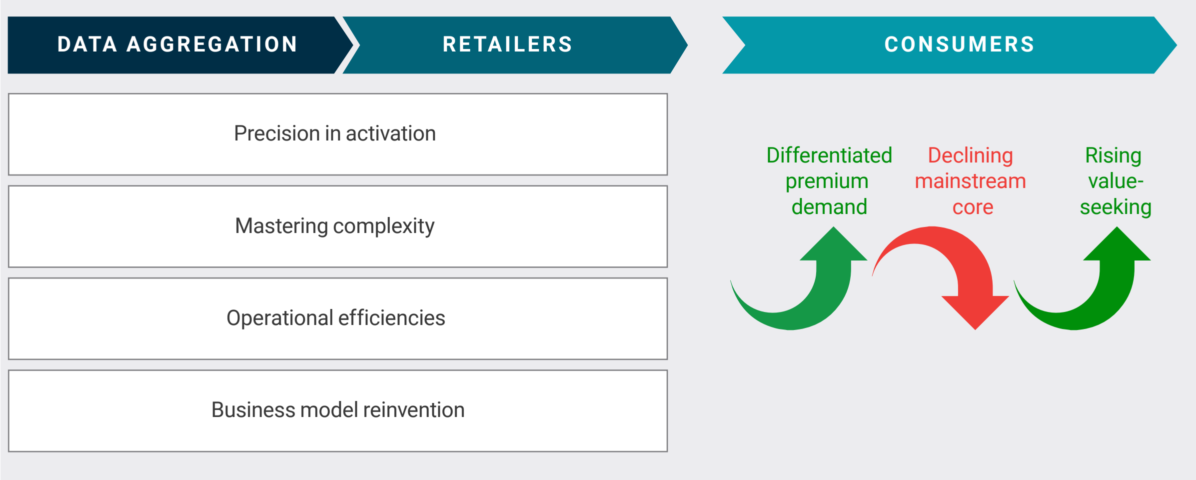
	PRIVATE LABEL PERCENTAGE SKUS		PRIVATE LABEL PERCENTAGE FACINGS		
	High income	Low income	High income	Low income	
Discounters #1	100	100	100	100	Consistent range and mix
Discounters #2	50	50	46	46	Consistent range and mix
Mainstream #1	47	47	31	54	Consistent range and **tailored mix**
Mainstream #2	50	50	41	52	Consistent range and **tailored mix**
Mainstream #3	25	8	25	7	**Counter tailored range and mix**
Convenience #1	33	50	33	50	**Tailored range and mix**

NO CLEAR CONSISTENT APPROACH UTILISED ACROSS UK RETAILERS

Source: Planet Retail data, AlixPartners analysis

[3] We visited nearly 40 stores – discounters, mainstream retailers, and convenience stores – in different income zones in London, Boston, Frankfurt, and Mumbai. The visits took place in April 2017.
[4] The study looked at all private label vs. all national label SKUs in the stores – but the national label brands had a much higher average €/kg than the private label.

FIGURE 4: A FRAMEWORK FOR SURVIVING AND THRIVING



Source: AlixPartners analysis

that income inequality creates, consumer businesses cannot ignore the enormous amounts of available data that can help them understand markets down to an unprecedented level of detail. This requires building a mix of strategies that include data aggregation, advanced analytics, and data visualization (figure 5).

They will need to synthesize not only vast arrays of external data, like Google maps, city census information, and detailed economic data, but they should also harness proprietary data like focus group transcripts and store sales information. Additionally, there is still no substitute for pounding the pavement, or visiting neighborhoods in person, to understand the behavioral patterns of the consumers who live there.

With so much data now available, retailers and consumer goods manufacturers have an unprecedented opportunity to synthesize it into a multidimensional view of consumers and their locales (figure 5). The key questions are how they can use big data to evolve their business models to address a wider segment of communities—and what that means for their operating models.

Mastering all dimensions of complexity

Complexity will only increase as the historical price-value relationship continues to shift. The historical (and simple) tiering from store brands, to mainstream, to niche will change as income inequality heightens. This will create a proliferation of brand positionings, package formats, and sub-brands as people try to stratify their brands (figures 6 and 7). To add to this complexity, each region has its own set of micro-regions. The city of Boston, to cite just one example, has 37 different zip codes, each spanning a wide range of incomes, from under $25,000 to more than $200,000. Still, our study found that Boston retailers offered either a barely tailored or an entirely counterintuitive range and mix of private label cleaning products across these different neighborhoods.

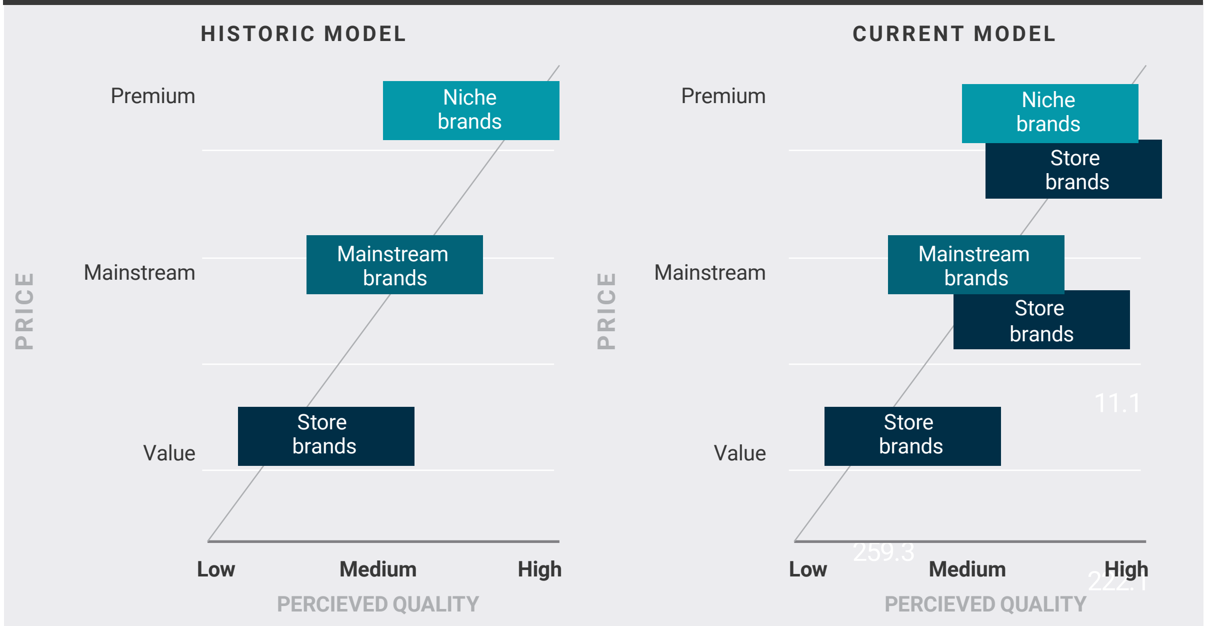
It is critical for both retailers and manufacturers to understand store surroundings and have models that can adapt accordingly. These challenges create an opportunity for manufacturers and retailers to work together to optimize their value chains and target the right customers with the right product offerings in the right areas.

FIGURE 5: USING DATA EFFECTIVELY

DATA AGGREGATION	ADVANCED ANALYTICS	DATA VISUALIZATION
• Internal data • External data • Geo-location data • Attributes of specific customers	• Past trend analysis • Multi-variant analysis • Predictive modelling	• Management dashboards • Data visualize • Enhanced decision making • ‘Seeing the wood for the trees’

Source: AlixPartners analysis

FIGURE 6: CONSUMER GOODS HISTORIC AND CURRENT MODELS



Source: AlixPartners analysis

Capturing operational efficiencies

Beyond the tactics we discussed above, consumer businesses must also keep themselves lean and efficient. Retailers must determine how to manage private label efficiencies and monitor inventory levels to avoid creating too much assortment. Manufacturers must also optimize their portfolios, tailoring them to broaden their reach across the price-value spectrum. They must also find efficiencies in operations and the supply chain by building global scale. Indeed, the recent wave of major consolidation within subsectors will continue as companies seek to further drive efficiency and build global scale. Digital transformation offers an additional avenue for achieving the new efficiencies.

Reinventing business models

Companies must ask themselves what their business models should look like going forward. How do they stimulate organic growth and defend their current market shares in shifting economic markets? Retailers must ask themselves whether to trade up or down, go mainstream or premium. As manufacturers develop much more differentiated product offerings to hit different price points, they will need to determine the business model required for global brands and how to manufacture and deliver them in a world of micro-targeting. For example, distribution models will become more complex as brands are adjusted and manufactured closer to their destinations.

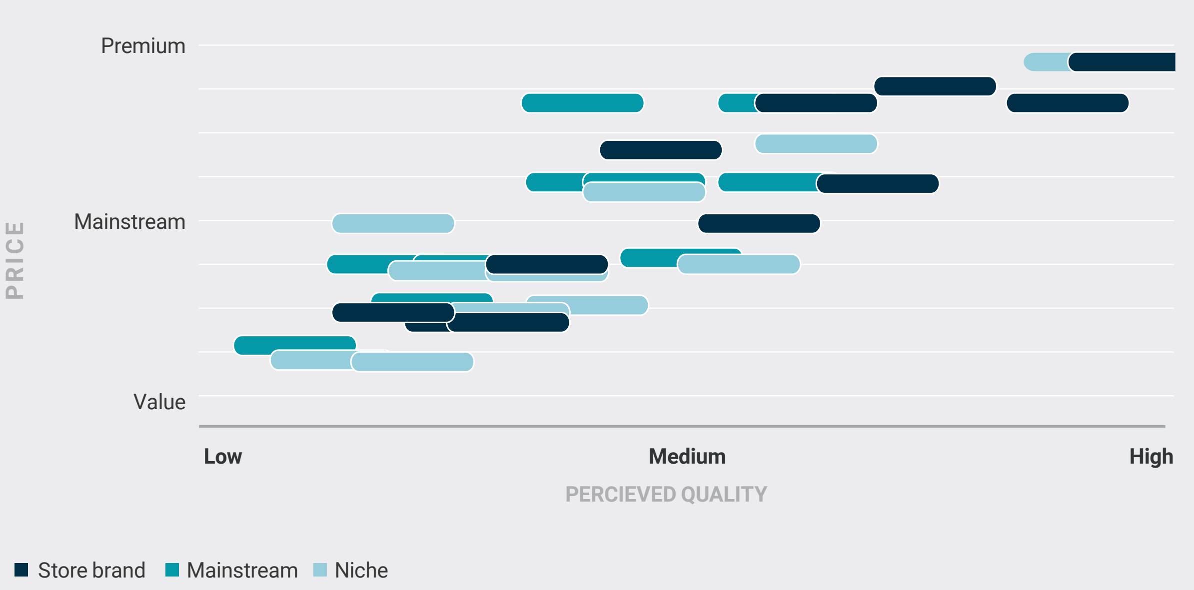
Given the challenges ahead, consumer businesses cannot simply tweak their product offerings. They must rethink their entire business models. Retail and manufacturing companies will continue to evolve as they try to reach consumers in a more targeted way. Here are some approaches that have been taken:

- Some of the largest companies have become cost-focused consolidators and focused on blockbuster mergers. Their business models are anchored in cost reduction through synergies and increased scale.
- Smaller companies have become niche innovators, gaining share at the expense of larger companies. These innovative startups typically identify a gap in the marketplace and develop a new product to meet niche consumer demand, often selling directly to consumers and bypassing traditional retailers.
- Other companies find themselves between these two models. They have not given up on the goal of topline growth, but rather than drive organic growth internally, they instead buy smaller companies as the primary way to drive growth and continue to spend money on innovation internally.

THE CHALLENGE OF INCOME INEQUALITY

During the last 20 to 30 years, success in the consumer goods industry depended on mass marketing, a fairly stable product portfolio of powerhouse brands, strong shelf presence, economies of scale and, most recently, an increasingly global consumer base. The efficiencies of a global supply chain enabled many global brands to offer lowered prices, which meant people spent less on necessities and could spend more on discretionary items—developments that have also brought many

FIGURE 7: CONSUMER GOODS FUTURE MODEL



Source: AlixPartners analysis

more items to emerging markets. It was a more homogeneous market, which made it simpler to sell to consumers.

However, as inequality worsens, middle-class consumers are feeling the squeeze. They are spending less and less of their disposable income on discretionary items.

Today, the consumer is in charge. Those in the stagnating middle class are making more complicated choices than ever before. Rising income inequality challenges the business models underpinning the entire consumer goods industry. For manufacturers, challenges include:

- Heavy reliance on core consumer segments, with increasing value demands.
- Contradictory pressures for SKU rationalization and proliferation.
- Losing share and shelf space to 'value' or private label products.
- Gaining traction with new product development.

Challenges for retailers include:

- Confusing customer behavior and fragmentation of customer profiles.
- Losing share, customers, and spend to discount channels.
- Managing assortment rationalization while offering appropriate value.

Both retailers and manufacturers will also need to build organizational capabilities to understand and manage the above issues.

Clearly, the industry must respond. The question is how far it will go. **A**

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