Executive Insights

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The Next Wave of Private Label

In the midst of the Great Recession during 2008, grocery penetration of private-label products increased more than it did in any other single year in U.S. history. Since then, however, penetration has stagnated, leading some industry watchers to declare that private label is at the end of its runway. We say, not so fast.

In contrast, a number of compelling reasons lead L.E.K. Consulting to believe the next wave of private-label growth actually might be right on the horizon. Some organizations are already ahead of the curve, as demonstrated by Kroger's approximately $1.5 billion Simple Truth line. Well-informed industry participants should be planning now to get ahead of the next wave before it arrives.

The case for growth

The next recession. Private-label products tend to get a boost when the economy is struggling and consumers are trading down. During the previous recession, retailers and manufacturers scrambled to capitalize on one of the few bright spots in the down market, causing a flurry of private-label activity. As of this writing, we are currently in history's third-longest period of time between economic downturns, and we will set a new record if we make it two more years without slipping into a recession. It's not a matter of whether we will hit the next recession; it's a matter of when.

Private-label penetration rates in Europe are much higher than in the U.S. While we expect a similar upward trend in private-label products the next time the economy heads south, it may not take a recession for them to experience a growth spurt. Perhaps one of the most compelling indications of this trend is private-label performance around the world, particularly in Europe, where penetration exceeds 40% (see Figure 1).

Consumer sentiment in the U.S. is shifting. Some pundits point to higher private-label inroads in Europe as a function of fundamentally different consumer preferences. There is some truth to this, but increasing evidence suggests American consumers' "addiction" to established brands is waning. According to Nielsen's Global Private Label Report, among a sample of 27,000 consumers, the percentage who agree that "private labels are a good alternative to name brands" jumped from 42% to 75% from 2011 to 2014. Consumers who believe "most private labels' quality is as good as name brands'" increased from 37% to 67% during the same period.

Underlying changes in consumer demographics are a big factor in this shifting sentiment. For example, millennials tend to be more distrustful of "big food" brands than boomers. These younger consumers are more inclined to reject packaged foods with long ingredient decks — where brands excel — and to seek out "clean–label" products that don't benefit from branding. This trend is especially evident in private-label growth in fresh-to-go foods at the store perimeter. By 2020, millennials will replace baby boomers as the generation with the highest discretionary spending power — 40% versus baby boomers' 21% — giving them enormous sway over what grocers ultimately stock on their shelves.

The Next Wave of Private Label was written by **Rob Wilson**, **Manny Picciola** and **Chris Randall**, Managing Directors in L.E.K. Consulting's Consumer Products practice.

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"The Germans are coming." We are about to witness the aggressive U.S. expansion of two enormously successful German discounters: Aldi and Lidl. These two retailers lead private-label growth in Europe, far outstripping their rivals. Between 2009 and 2014, they saw compound annual growth rates of 7% and 8%, respectively, while total European supermarkets and superstores grew at a meager 1%. Both chains are looking to repeat their triumphs in the U.S. market, with Aldi expanding rapidly in the United States to become a top-20 grocer and low-cost Lidl announcing plans to open approximately 150 stores by 2018.

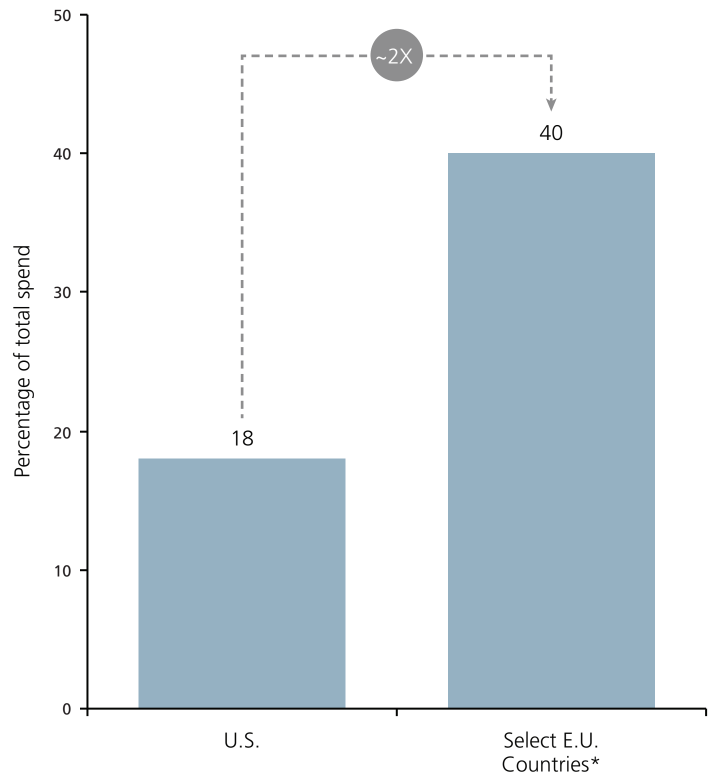
Moreover, many U.S.-based chains are taking a page out of the Aldi/Lidl private-label playbook. Trader Joe's, which is actually owned by Germany-based Aldi Nord, sells primarily private-label items and has been growing revenue at 10% annually since 2008. In May 2016, Whole Foods began rolling out its new line of stores, 365 by Whole Foods Market, as part of its strategy to capitalize on the consumer appeal of private label and to compete more effectively with Trader Joe's. About half of the new chain's nonperishable products will be Whole Foods' own 365 private label.

Market implications

Premium and specialty products are the next wave to be converted. Private label has left its dull beginnings behind. No longer relegated to mere flour, sugar and other commodities, private label has branched out into salsa, granola and even prepared foods. As consumers' thinking about private-label brands has evolved, the category has outgrown its no-frills, "just the basics" image for the economically constrained and is now viewed as an intelligent choice for the savvy shopper. This opens up enormous opportunities for private-label manufacturers and retailers alike to convert additional premium and specialty categories.

Some retailers have started to transform their offerings from commodity knockoffs to higher-end and specialty products. For example, Aldi has added private-label brands of products that are free of gluten, antibiotics, hormones and other additives. In 2012, supermarket chain Kroger launched its Simple Truth house brand, whose products sport straightforward ingredient labels and are free of 101 ingredients that Kroger has identified as being of concern to its customers. Simple Truth has grown rapidly, reaching an astounding milestone of approximately $1.5 billion in sales at the end of 2015.

Figure 1
Private-label dollar share by country



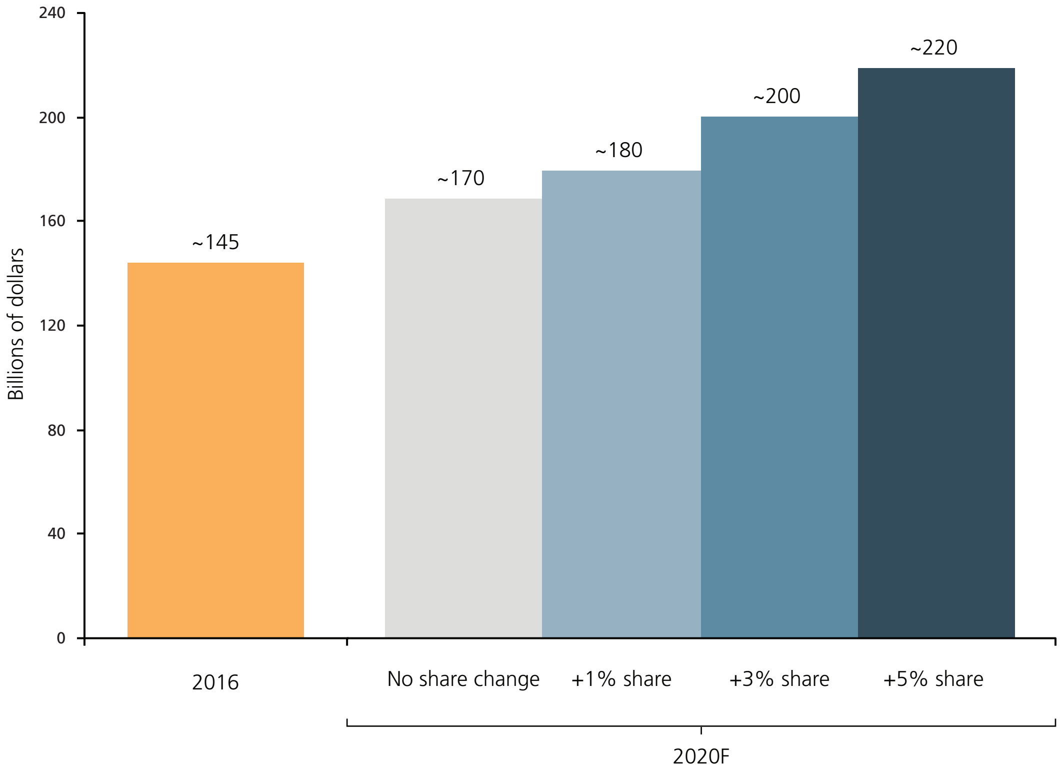
*Average of U.K., Spain, Germany and Switzerland

Enhanced "good/better/best" strategies meet the needs of consumers. Retailers will need to develop or revamp private-label strategies in order to go beyond their current basic offerings and meet a variety of consumer needs. This will likely include a continued evolution toward a tiered approach with "good/better/best" brand positioning that uses different price points to capture a broader range of consumer segments and preferences.

Some branded suppliers that also have private-label businesses will struggle with this when a premium offering puts them at odds with their own branded counterparts. "Pure play" private-label suppliers, which are able to avoid such internal conflicts, would do well to seize on this opening in the market.

Fresh-to-go/perimeter growth is inevitable. Anyone who has shopped M&S in London would agree that the prepared foods offerings in the U.S. have a long way to go. For the most part, fresh-to-go has been unimaginative and poorly executed in the U.S. market, but strong evidence suggests that retailers are starting to figure out what works. The approximately $11 billion

Figure 2
U.S. private-label supermarket growth



Additional private-label revenue in 2020F	
No share change	~$25B
1% share increase	~$35B
3% share increase	~$55B
5% share increase	~$75B

Note: Assumes total supermarket sales are valued at $800 billion in 2014 and the underlying market grows at ~3% p.a. from 2014 to 2020
Sources: L.E.K. analysis of FMI; Progressive Grocer Magazine

fresh prepared foods category is growing at 10% each year, and leading retailers (such as Whole Foods) have moved beyond unappealing sushi to create offerings that blur the lines of retail and foodservice.

The focus on strategic sourcing is increasing. As private label regains its momentum, grocery retailers in the U.S. are likely to sharpen their focus on strategic sourcing, for two reasons: (1) They will need to find suppliers that meet the premium conversion needs noted above, and (2) as purchases surge, retailers are likely to recognize the tremendous opportunity in consolidating volume among existing supplier bases that tend to expand over time. By moving from a "low bidder" transactional procurement model with many suppliers to a long-term partnership model, retailers can forge strategic relationships and drive increased margins in the process. This is no easy task because retailers must carefully study market, consumer and competitive dynamics within each category to build multiyear partnerships by awarding larger-volume contracts to fewer suppliers in return for slightly lower prices. But the reward sweetens the deal, often with millions of dollars in profit improvement per category.

Investment opportunities abound. A great deal of value can still be unlocked from private label. With all else holding constant, even a modest 5% increase in penetration between now and 2020 would result in more than $75 billion of private-label revenue growth (see Figure 2). Retailers will experience increased demand for a broad range of private-label products, which, in turn, should lead to significant opportunities in the premium and innovative private-label categories, including fresh-to-go. Manufacturers that are innovative but can keep costs low will win with private label, making the ability to scale an important competitive advantage. For this reason, consolidation and roll-ups are likely to continue.

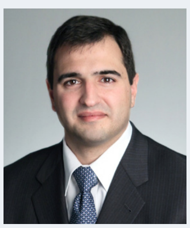
Catching the next wave

The implications of private label to your current business and go-forward investment strategy depend on your position in the supply chain:

- **For retailers:** A category-by-category approach for your private-label brands is required in order to strategically place a full offering with the right suppliers and better meet consumers' needs with a "good/better/best" offering.
- **For private-label manufacturers:** Investing in innovation capability will allow you to not just "knock off" national brands but also to deliver a true "good/better/best" approach for retail partners.
- **For branded consumer packaged goods companies:** A more sophisticated private-label strategy will challenge national brands. Having a strong connection with consumers, an authentic proposition and a price pack architecture that meets consumers' needs across the value continuum can mitigate the impact.

Evidence indicates the next wave of private label is impending. Are you taking steps now to catch it early and avoid crashing on the rocks?

About the Authors



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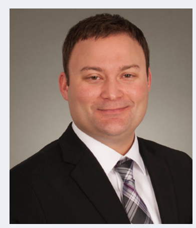

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