

How consumer-facing companies can speed up, as economies slow down (PART 1)



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A recession is coming — consumer products and retail companies that can take it as an opportunity to innovate are likely to emerge stronger.

In brief

- Inflation, rising interest rates and market volatility are signs the global economy is heading for a downturn.
- Consumer products companies and retailers that can invest strategically while competitors are struggling stand to emerge as winners.
- While all recessions are different, companies can learn from those that succeeded through previous hard times by focusing on growth and value.

As dark clouds of recession gather, many consumer products (CP) companies and retailers may be tempted to adopt a defensive posture and prepare for lean times. However, companies that approach it as an opportunity to invest in innovation, cost efficiency and brand differentiation stand to emerge stronger.

Persistent inflation, higher interest rates and market volatility indicate a global economic downturn is coming – or indeed may already be here – and the only real question, according to economists, is whether it will be short and mild or protracted and severe.

CP companies and retailers are likely to be caught between rising costs and weakening consumer demand as price increases hit household budgets. Leaders should plan for multiple scenarios – including an environment of more persistent inflation, elevated interest rates and a globally synchronized slowdown – and what these may mean for the business.

While lessons learned from past recessions may be helpful, the current situation is different in many ways. Still, experience from past downturns suggests that CP companies and retailers that take a proactive stance, for example, by maintaining advertising spending and seeking to differentiate their product portfolio, rather than simply cutting costs and lowering prices, can find ways to preserve value and profits even in a downturn.

Some examples are companies like Lego, Netflix and Walmart, which all grew during the 2008 recession because of new products and investments.

In this article, we describe what is different this time compared to prior recessions, what is likely to come, and what CP companies and retailers can do to prepare and build resilience.

CHAPTER 1

The underlying drivers of a recession are different from the past

The spark this time is inflation, not the financial crisis.

CP and retail executives are making decisions in an environment dominated by inflation, which is at a 40-year high because fiscally stimulated demand during the early stages of the pandemic in the US, persistent supply constraints and the war in Ukraine, caused a rapid escalation in energy and commodities prices.

With central banks around the world tightening monetary policy extremely rapidly, the current environment is very different from the 2008 crisis, which was triggered by the US housing market bust and subsequent collapse of financial markets. Where the 2008 downturn was exacerbated by a massive household deleveraging cycle and accompanied by widespread job losses, household finances remain relatively healthy

today, and the labor market appears robust – for example with the US unemployment rate at a 50-year low.

And while policymakers responded to the 2008 crisis by cutting interest rates and launching an asset purchase program (quantitative easing) to encourage spending and investment, today's policymakers are intent on raising interest rates and tightening financial conditions to combat inflation.

The downturn will affect regions differently

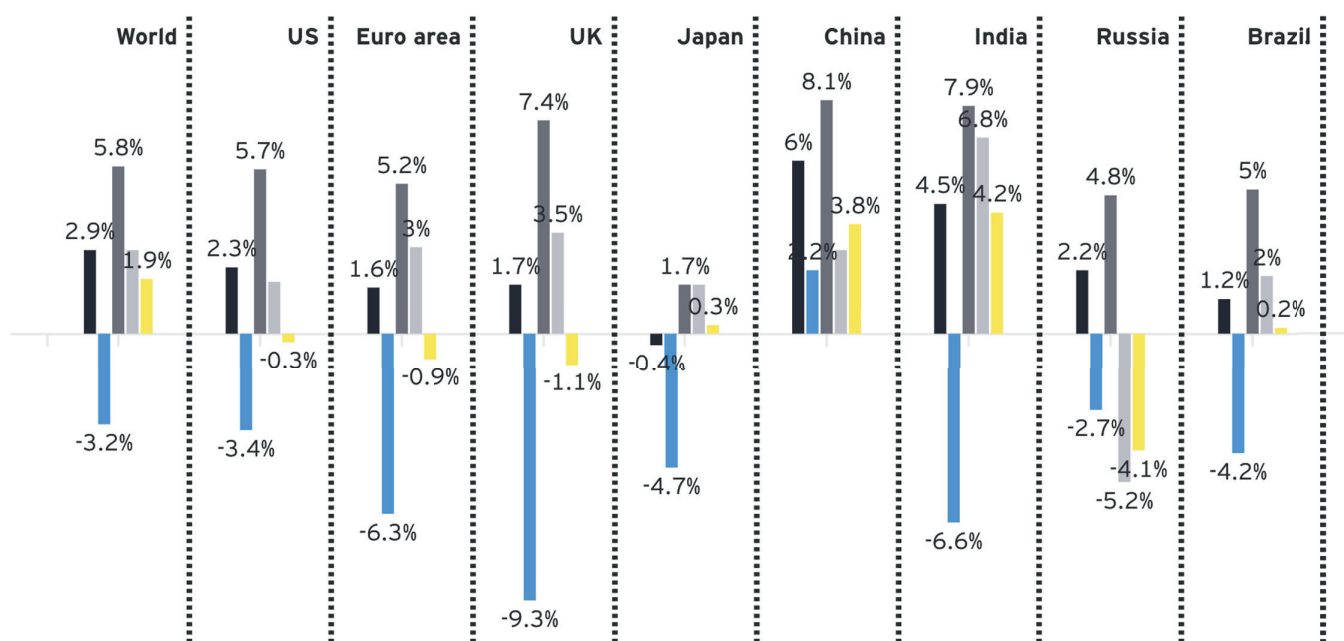
Globally, the economic landscape is complicated by elevated macroeconomic uncertainty, ongoing geopolitical tensions and constrained product and labor supply.

In Europe, economic activity is rapidly cooling with elevated inflation weighing on consumer and business outlays and forcing the European Central Bank to tighten monetary policy at the fastest pace since 1999. Europe's energy situation is particularly concerning, and while government action to minimize energy shortage risks and shield households from surging energy prices may avoid the most somber of outcomes, energy supply disruptions will remain a key concern over the next couple of years. ■

(CONTINUED IN NEXT EDITION)

Year-on-year percent change in real GDP* 2019 - 2023F

■ 2019 ■ 2020 ■ 2021 ■ 2022F ■ 2023F



Source: EY-Parthenon research
*GDP = gross domestic product

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How consumer-facing companies can speed up, as economies slow down (PART 2)



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(CONTINUED FROM PREVIOUS EDITION)

In Asia, real GDP growth has slowed sharply in mainland China with household spending, housing activity and manufacturing output restrained by the zero-COVID-19 policy and a worsening property sector downturn that has led some people to boycott mortgage payments. The slowdown in economic activity in China is weighing on growth across its major Asian trading partners. Meanwhile, in Japan, the post-COVID-19 pandemic consumer spending recovery is still not complete, and momentum is slowing as higher inflation is squeezing household incomes.

In the US, the high inflation environment is weighing on consumer morale and purchasing power, and it is forcing many households to dip into savings and borrow to finance outlays.

While consumers remain willing to spend, many families, especially those at the lower-to-median end of the income spectrum, are feeling increasingly constrained by elevated prices and rising interest rates.

Consumers have evolved

More than ever, brands are investing in ways to develop stronger consumer relationships, and companies that can continue to find ways to anticipate consumers' needs and improve the buying experience are likely to fare better in downturns.

The COVID-19 pandemic significantly affected consumers around the world, hastening the adoption of new values and behaviors. Greater access to information and choices in the products they buy have driven down loyalty, enabling them to switch brands easily. Consumers' expectations of the companies they buy from are higher and they continue to be more concerned with sustainability, wellness and social issues.

Under the strains of the pandemic, consumers forged new buying habits driven by the desire to work and shop from home, and many switched to private label products to economize. As we move into an uncertain landscape, many of the habits solidified during the pandemic are proving helpful now.

There are signs people may already be reining in spending in anticipation of difficult times. The November 2022 edition of the EY Future Consumer Index shows that people are worried about the future, with 62% not expecting the economy to recover within the next 12 months and 58% expecting their living costs to increase over the next six months. Their fears are being reflected in a change of behavior:

- ▶ 34% of consumers are substituting their normal purchases with new brands, and 28% are switching to private label
- ▶ 52% would consider buying private label home and household care products
- ▶ 50% are purchasing less expensive alternatives

EY Future Consumer Index

62%

of global consumers do not expect their country's economy will recover within the next 12 months.

CHAPTER 2

Challenges bring opportunities

The recession presents challenges but also opportunities to gain a competitive edge.

The trends present challenges and opportunities, for both CP companies and retailers. Companies in both sectors will be squeezed between inflationary costs – from transportation to labor – and weakening demand as consumers become more sensitive to rising prices and interest rates.

To compete effectively, brands need to reinvent their relationship with consumers, who are seeking meaningful differentiation from the companies they buy from, not just brand promises. Their products need to tell a story that shows how they can have an impact in areas that matter to consumers, such as health and wellness, higher-quality ingredients or sustainable environmental impact.

With the access today's consumers have to multiple shopping channels and vast information sources, it's important for companies to be visible. Retailers have physical stores, but digital channels are available to all, and CP companies can benefit from developing independent channels such as direct-to-consumer.

Companies that combine these efforts with changes to improve efficiency, such as creative uses of technology, can gain a competitive edge. Digital solutions are especially important because they can be the basis for significantly improving consumer relationships.

Consumer products: Connect with consumers with value adding strategies

In past recessions, many CP companies pulled back on marketing and advertising spending to cut costs. Those that did this, however, found that their smaller "share of voice" hurt brand awareness and market share once the economy picked up again.

Savvy competitors maintained their marketing spend and were able to gain market share in many cases. For many companies, the lesson is to resist the temptation to cut marketing expenditures, and, where possible, hold marketing and advertising budgets steady or even increase them to grow share of voice.

As companies invest in their brand, they will need to think carefully about their message to get the most from their advertising budget. Organizations need to align their approach with consumer values such as the demand for greater authenticity and transparency, personalization, emphasis on health and the environment, convenience and value. Instead of cutting prices, companies can add value to product portfolios through a combination of product innovation and premiumization with strategies that create opportunities to connect with consumers and their evolving expectations.

Pricing considerations will be of paramount concern, and, in an inflationary environment companies will need to maintain profitability by managing the squeeze between elevated input costs and weaker demand as price-sensitive consumers pull back on outlays and shop for less expensive alternatives. To do this, many companies will need to offset rising input costs by increasing the value of their products and increasing productivity. Price-sensitive consumers will shop for lower cost alternatives, but value-driven consumers will remain loyal. Low-demand products, on the other hand, will face substitution or delisting from major retailers.

As retailers emphasize own-label products and reduce shelf space for brands, CP companies must re-evaluate channels to consumers. CP giant Unilever is an example of a company that has invested in its direct-to-consumer capabilities while expanding its global reach. It partnered with the Chinese e-commerce company Alibaba to launch a new digital incubator to create new beauty and personal care brands for an online flagship store to reach more customers in China.

Companies can also explore opportunities to expand footprints in high growth markets and can consider reshaping the core business through M&A, such as considering

value-led, sustainability-related growth opportunities, or through divestitures or spin-offs, to generate new value.

Japanese beer maker Kirin is going through such a transition, diversifying its traditional beverage line to reposition itself as a health beverage company. New products include probiotic drinks, teas and alcohol-free beer. It is also spending to improve its environmental image with new programs for sustainable packaging, supply chain operations and plastic bottle recycling.

ACTIONS TAKEN THEN AND NOW

- ▷ In 2008 and 2009, a US-based food products company acquired premium alcohol brands and revaluated its product mix across its core markets, and increased focus on premium and high margin brands. The premiumization strategy helped improve gross margin by 3.7% in the third quarter of 2009.
- ▷ A German beauty and home goods company is preparing for a likely recession by launching multiple products in new categories, such as beauty care, laundry and home care. It invested in a new innovation center in 2022, expanded production capacity and has acquired a company to increase its direct-to-consumer and digital capabilities. It has also made cost optimization moves and invested in sustainable product packaging. ■

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Retailers: efficiency, balanced pricing approach and private label emphasis

Retailers can adopt similar pricing approaches that are likely to work for CP manufacturers, such as discounting lower-demand products and reinvesting in high demand products.

In an example of the approach some companies are already taking in the fluid environment, many retailers have reacted to abating energy and shipping costs in the third quarter of 2022 by maintaining high product prices to conserve margins.

With consumers buying less or seeking lower price alternatives, retailers can also benefit from consumers' broader acceptance of private labels and value brands by introducing these in more discretionary product categories as shoppers show a willingness to switch. We are seeing many grocers introducing new budget price ranges and being rewarded with high demand from shoppers.

The EY Future Consumer Index found that 28% of consumers are planning to buy more store-branded products in the future. This rises to 61% of consumers who are willing to try store-branded fresh food and 53% who are willing to try store-branded packaged foods.

Another strategy for retailers to consider is rationalizing stock-keeping units (SKUs) to increase focus on high-margin products. Additionally, streamlining the inventory procurement process allows retailers to:

- ▶ Minimize purchasing lead times
- ▶ Enhance inventory visibility
- ▶ Enable the cash conversion cycle
- ▶ Ensure greater flexibility to adapt to changes in consumer behaviors and economic conditions

An example of a company that benefitted from SKU streamlining is an American food and tea company that reorganized the products in its personal care segment in 2008 to focus on high margin items only. Between 30 and 40% of SKUs were discontinued, which helped increase SKU velocity, reduced working capital and business complexity and improved operating efficiencies.

Retailers have opportunities to deepen the connection with shoppers by educating them on how to get the most for their money and from the products they buy. They can promote recipe ideas that make food go further; and are driving sustainability by wasting less - retailers in some countries have acted to remove unhelpful "best before date" stickers from some products and are once again promoting ugly fruit (a must, given the heatwave-stricken harvests across Europe).

Organizations can consider the efficiency of their store footprint to reduce store-related expenses while reallocating capital to online channel innovation. Successful companies are using technology, such as data analysis and automation to contribute to unconventional retail staffing approaches. For example, companies EY has worked with are using retail "rescue squads" to support teams at understaffed stores, [category-level analysis to improve staffing allocations](#) (via ey.com US) and special programs with schools to hire work-eligible students for simple tasks.

ACTIONS TAKEN THEN AND NOW

- ▷ In 2008-2012, a US retailer adopted a strategy that combined defensive financial streamlining with a revised marketing strategy to increase three-year total shareholder return by 103%. It reduced its debt-equity ratio, streamlined stores and SKUs, and increased supply chain efficiency through improved packaging, use of cross-docking centers and truck-weight optimization and efficiency. It changed its marketing strategy, shifting away from big ticket and discretionary items toward consumer staples and an increased focus on its private-label brand.
- ▷ The 2008 recession saw the rapid rise of discount retailers, whose value proposition of low prices on a limited range of private label products became the industry standard and pushed them into the mainstream, driving a growth trajectory that has persisted to this day.
- ▷ A British DIY retailer opened 38 new "compact stores" (less than 2,000 square meters) in 2021 to increase penetration in urban areas, while also rolling out new brands in kitchen and lighting areas. It has also invested in technology upgrades to improve its e-commerce capabilities.

Weathering the storm

CP companies and retailers may also find it useful to combine strategies for growth in some areas with financial belt-tightening or efficiency moves in others.

- ▶ Reduce leverage now as much as possible to conserve cash, improve access to capital and prepare for the rising cost of servicing debt
- ▶ Reduce back office and cost-of-goods-sold overheads to optimize prices while maintaining enough cash and margin buffer to weather a more sustained recessionary period
- ▶ Pursue asset-light opportunities to curtail overhead costs and focus only on core operations. For example, companies can rationalize product portfolios and consider the impact of private label and how to counter it (for CP) or exploit it (for retail)
- ▶ Consider various steps to reduce costs and increase resiliency in their global supply chains.
- ▶ Increase communications and commitment to key vendors to have the right goods in the right place at the right time to limit supply chain disruption.
- ▶ Invest in technology integration across the value chain, including automated vendor management, artificial intelligence and machine learning in demand planning, augmented or virtual reality in selling and autonomous delivery.

ACTIONS TAKEN THEN AND NOW

- ▷ A major home improvement retailer generated US\$5.1 billion of cash flow from operations in 2009 and was able to reduce its long-term, debt-to-equity ratio to 44.7% compared with 54.4% at the end of fiscal 2008.
- ▷ A US-based home products chain combined cost-cutting steps with strategic growth moves. It reduced planned capital expenditure by 37% in 2022 and closed 150 underperforming stores in addition to other cost-cutting measures. The company divested a retail business to streamline its portfolio and product line and invested in new distribution centers and IT systems to strengthened supply chain infrastructure. The company has made strategic, market-facing investments, as well as, expanding its store network through a new partnership and

augmenting its customer loyalty points program across its different retail brands.

Summary

It may seem counterintuitive to view recession as a time to focus on innovation and growth levers, but experience shows that retailers and consumer products companies that can prepare for the coming downturn with an emphasis on a value, growth and a consumer-centric marketing approach are likely to outperform their competition in the long run. While executives should be aware of the current downturn and how it is different from past recessions, valuable lessons can be learned from companies that succeeded through tough times in the past by investing in innovation to grow while also improving operational efficiency and reducing costs in non-strategic areas. ■

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