Consumer Packaged Goods Practice

Reimagining consumer-goods innovation for the next normal

As the COVID-19 pandemic continues and new consumer behaviors play out, it's time for manufacturers to reimagine their innovation portfolios to lead in the next normal.

by Stacey Haas, Jon McClain, Paul McInerney, and Björn Timelin

October 2020

Business leaders and consumers have adapted after the initial shock of the widespread lockdown that followed the outbreak of the COVID-19 pandemic. Demand patterns have started to normalize, supply chains are largely stable, and shelter-in-place orders are being lifted and replaced by physical distancing across the United States.

Although many consumer-packaged goods (CPG) leaders have come to terms with the crisis, they are still challenged to know what comes next. Seventy-nine percent of the executives responding to a survey believed that the COVID-19 crisis would have a lasting impact on their customers' needs in the next five years. But fewer than 30 percent of all executives felt that their companies were well equipped to address such changes. Even fewer—only 10 percent of all executives—believed that they were well equipped to pursue net new growth[1] and M&A.[2]

The foundation for profitable growth

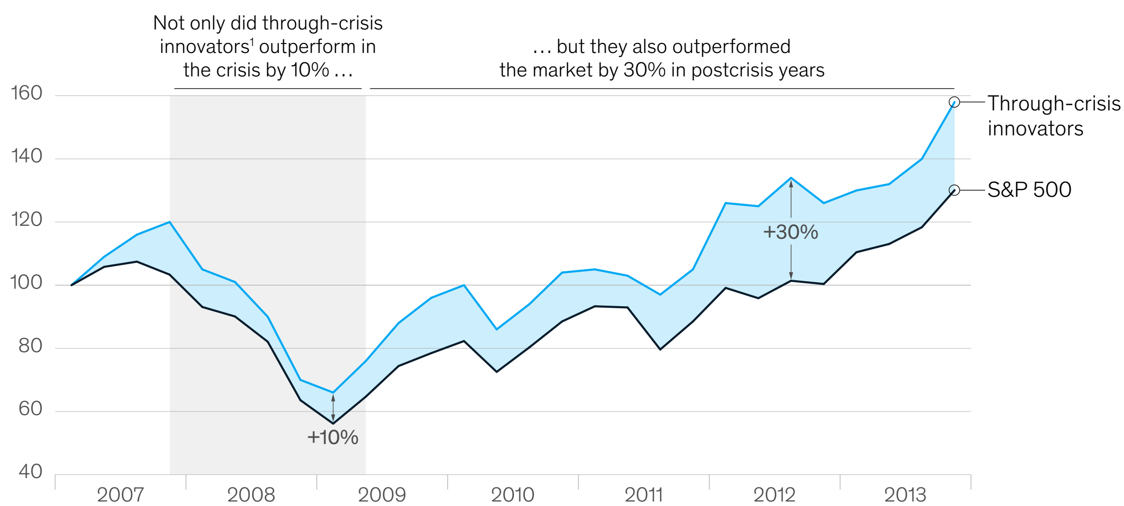
We see a three-step predictive growth process as the foundation for profitable growth: first, predicting levels and areas of growth in consumer consumption and spending; then, transforming growth levers in response; and, finally, sustaining growth with operating-model changes. Consumer behavior and engagement with products, brands, and channels have changed so much that innovation must now be top of mind for CPG leaders.

A midcrisis answer to what's next on the innovation agenda is crucial for delivering outsized performance. During the first five years after the Great Recession of 2008, CPG leaders that could answer this question outperformed the market by an average of 20 percent (Exhibit 1).

Exhibit 1

History suggests that companies that invest in innovation through a crisis outperform peers during the recovery.

Normalized market capitalization, index (Q1 2007 = 100)



[1]Identified as companies on *Fast Company*'s annual list of world's 50 most innovative companies for ≥2 years through a crisis, normalized to 2007.

[1] Net new growth is growth delivered organically beyond the core, through new products, services, or business models. It does not cannibalize the existing product portfolio.
[2] Jordan Bar Am, Laura Furstenthal, Felicitas Jorge, and Erik Roth, "Innovation in a crisis: Why it is more critical than ever," June 2020, McKinsey.com.

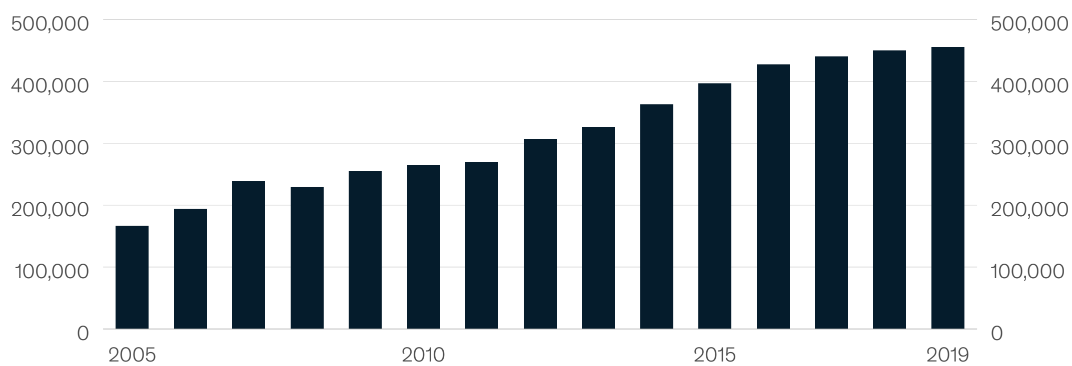
Most CPG companies reduced the pace of innovation back then; in fact, 2008 was the only year in the past 15 when innovation activity declined (Exhibit 2). Yet small brands and other innovators continued to develop disruptive offerings: new products, services, and business models paved the way for the gig-economy giants, direct-to-consumer (DTC) startups from eyewear to pet food, and other innovations across the consumer landscape. These innovators looked beyond the immediate challenges and into the next normal, and manufacturers hoping to emerge stronger from the pandemic must do the same. What does the future hold in store this time around?

In an April 2020 article, we identified six key consumer behaviors, ranging from price sensitivity to unprecedented channel shifting, during the first wave of COVID-19. In several ways, consumer behavior jumped forward by years in a few weeks. As the pandemic has unfolded, we've seen the texture of these consumer trends evolve even further. CPG companies and retailers that accommodate these changing behaviors will probably emerge from the crisis stronger, putting pressure on competitors to keep pace. Three behaviors are particularly germane to the innovation agenda:

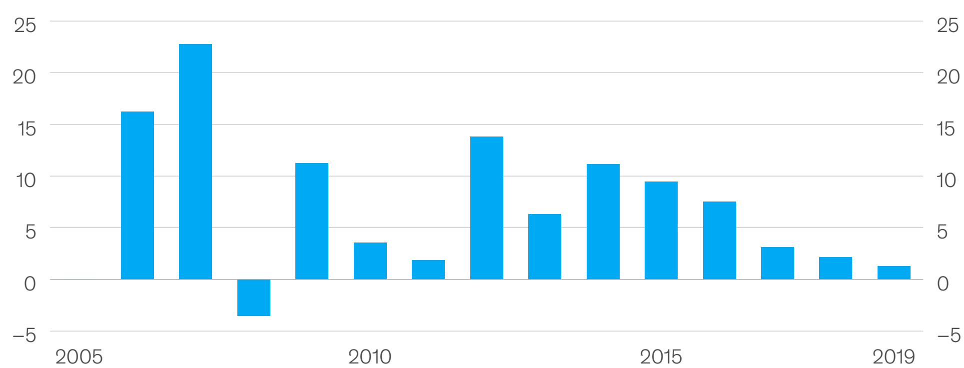
Exhibit 2

The consumer-goods industry's innovation activity in the United States was muted during the last recession before exploding in the years that followed.

Number of US product launches



Year-over-year change in number of US launches, %



Source: Mintel Global New Products Database, Mintel, mintel.com; McKinsey analysis

— *Trying new products.* In most categories, significant shares of consumers are trying new products (Exhibit 3). In some categories, almost half of all product purchases are new trials. On search engines, for instance, interest in previously away-from-home activities has exploded: to give one example, the use of the search term "at home workouts" has increased by 50 percent year over year globally as consumers rushed to try premium subscriptions. Apparel manufacturers, premium gym operators, and fitness-equipment manufacturers, among others, have all offered such subscriptions free of charge.[3] As categories experiencing tailwinds continue to grow exponentially, how will incumbents use trials to maintain their market share?

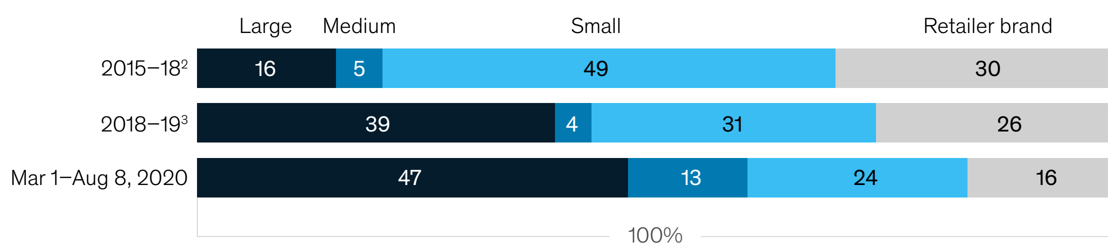
— *The resurgence of large brands.* Availability and trust have enabled large CPG companies to come back. Globally, consumers are opting for "brands they can absolutely trust"—from the United States (55 percent of consumers) to Europe (48 percent in Germany and 52 percent in the United Kingdom) and, in particular, Asia (89 percent in China and 77 percent in India).[4] Indeed, large brands have been the beneficiaries of about 30 percent of consumer-switching choices during the pandemic. Although consumer trials of new products increased, satisfaction rates for new products range only from 20 to 60 percent across categories, so redesigned branded products could have an opportunity to deliver more value. With consumers remaining somewhat unsatisfied, store brands did relatively well: 60 percent of consumers reported that the store brands they bought during the COVID-19 crisis represented good value for money.[5] In a recent survey, 90 percent of retailers said that they planned to increase shelf-space allocations for private labels.[6] Going forward, as the consumers' price–value relationship evolves, large brands versus store brands will be an emerging battlefield, just as it was during the Great Recession.

Exhibit 3

Trials of new brands are changing the growth composition of the consumer-goods industry.

Share of sales by company type, %

Share of growth by company type, %



Note: Companies sized by yearly sales (large: >$2.5 billion; medium: $500 million–$2.5 billion; small: <$500 million).
[1]Share for 52 weeks ending June 15, 2019.
[2]Share for 52 weeks ending June 20, 2015, through 52 weeks ending June 16, 2018.
[3]Share for 52 weeks ending June 16, 2018, through 52 weeks ending June 15, 2019.

[3] Craig Rubens, "The at-home consumer experience with time and space," Think with Google, April 2020, thinkwithgoogle.com.
[4] *2020 Edelman trust barometer special report: Brands and the coronavirus*, Edelman, March 2020, edelman.com.
[5] McKinsey COVID-19 Consumer Pulse Survey, April 2020.
[6] McKinsey Retail Practice Survey, May 2020.

— *Nesting at home.* Protracted physical distancing has encouraged mobile-first consumer mindsets, which are likely to persist. Digital engagement has continued to remain high: 80 percent of consumers report safe, easy, and convenient experiences in DTC channels. However, specific consumer-buying factors remain largely unaddressed: for instance, more than 60 percent of consumers identify expense and an inability to choose products as disadvantages of DTC channels.[7] Brands must continue to use personalization, the right social-media and mobile presence, and the right marketing message to capture their share of growth.

As communities continue to reopen, economic and public-health realities will inform consumer behavior in the next normal. But it will also be shaped by the response of manufacturers that seize the opportunity by offering breakthrough products and using innovative business models.

How should CPG companies reimagine innovation for the next normal?

In this context, we see four imperatives for CPG companies as they anticipate the next normal: renovate the core using recent trials as a springboard, reset the innovation pipeline to help consumers thrive in their new reality, accelerate DTC evaluation and testing, and harness new ways of working—including digital—to accelerate the development process.

1. Renovate the core using recent trials as a springboard

With consumers slowly returning to public spaces, how can major brands continue to deliver new, powerful experiences that build upon trials of new products seen thus far in 2020?

With a period of economic uncertainty ahead, store brands are poised to take share. During the Great Recession and the time that followed it, private-label sales rose by 10 percent, versus only 2 percent for branded products.[8] In the United States, private-label penetration now stands at only 18 percent across grocery categories. A look at Europe, where penetration stands at 32 percent, provides a view of the possibilities. In fact, 78 percent of retail buyers say they expect private-label growth to come at the expense of national and challenger brands.[9] The next normal's curve for private labels could very well be on the horizon.

This possibility means that branded manufacturers have a critical need to focus on their core brands and to simplify their efforts across the portfolio more broadly. The good news for large manufacturers is that the COVID-19 crisis has reestablished their market-leading position in many categories. In the 23 weeks ending August 8, 2020, such companies enjoyed 47 percent of all growth in the market, versus only 16 percent from 2015 to 2018.[10]

Although that represents a near-return to "fair share" for private-label brands, which had been growing in recent years, large brands should aim higher: they can build upon this momentum by redesigning their products to maximize things consumers value and to minimize costs for less relevant buying factors. To stave off the private-label threat, large manufacturers must amp up their renovation agendas for their core brands and rethink the approximately 75 percent of new-product development they now focus on line extensions.[11]

2. Reset the innovation pipeline to help consumers thrive in their new reality

Healthy innovation pipelines are developed with a multiyear view in mind. Of course, many projects currently being contemplated—or even developed—started before the COVID-19 crisis and therefore take no account of it or of the next normal to follow. Certainly, the heightened brand opportunity wasn't fully reflected in pre-COVID times (see sidebar, "A brand marketer speaks her mind"). With the new

[7] McKinsey COVID-19 Consumer Pulse Survey, April 2020.
[8] Richard Clarke, "Private-label sales boom as recession digs in," New Hope Network, April 1, 2009, newhope.com.
[9] McKinsey Retail Practice Survey, May 2020.
[10] McKinsey analysis of Nielsen POS data.
[11] Mintel Global New Products Database (GNPD), Mintel, 2019, mintel.com.

context in mind, consumer-goods manufacturers should review their project portfolios with an eye to the following (Exhibit 4):

— *Projects to accelerate or launch.* The current pipeline may not address some of the most attractive opportunities. Single-serve needs, at-home consumption, evolved shopping missions, and growing private-label competition will all dictate the new pipeline priorities. Understand which consumers you must target for repeat and loyal purchases, and diagnose how your pipeline trial rates, satisfaction rates, and price/value considerations will drive the overall net present value of your projects.

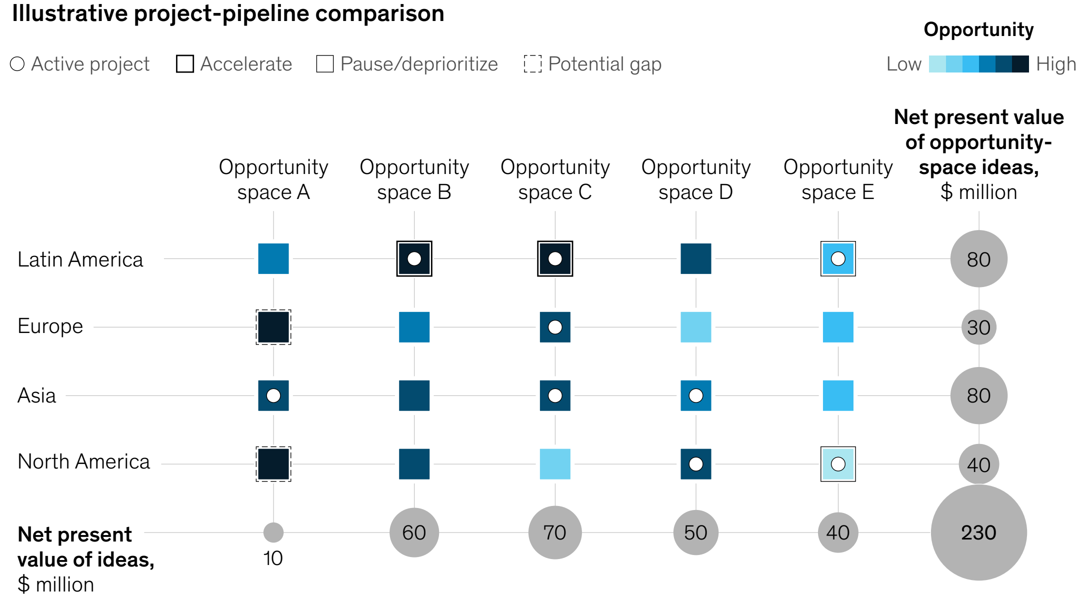
— *Projects to pause.* In other cases, the realities of the next normal may dictate a pause. Retailers have streamlined their assortments during the crisis, and the standard annual shelf reset is no longer a foregone conclusion. Line extensions, which represented 33 percent of all global product launches last year,[12] are the most likely candidates to reconsider. As we wrote in our recent article on measuring innovation incrementality, corporate mindsets must shift: instead of defining line extensions first and using the remaining resources for breakthrough innovation, companies should devote resources to line extensions only when necessary and only with clear, measurable goals.

Where might the opportunity spaces be most pronounced? The nesting behavior that the COVID-19 pandemic has prompted will create a new array of possibilities and challenges, especially in foodservice. According to Slackline, Amazon has grown its grocery business by 45 percent in the United States and by 80 percent in the United Kingdom. With this growth only set to accelerate as Amazon moves into brick-and-mortar stores, consumer-goods manufacturers should take a

Exhibit 4

Consumer-goods initiatives should be compared with an updated set of opportunity spaces that reflect the next normal.

Illustrative project-pipeline comparison



Source: McKinsey analysis

[12] Mintel GNPD, 2019.

A brand marketer speaks her mind

Jessica Spaulding is now head of Cheetos marketing at Frito-Lay. In nearly 12 years of marketing at PepsiCo, she has seen consumer behavior change—but not as profoundly as it has during the COVID-19 pandemic. The disruption has created opportunities, particularly for market leaders, with "strong companies only getting stronger," she says. But those opportunities do not come without challenges and big strategic questions.

New trials or reengagements have spanned categories. In food, this has meant that "consumers were definitely looking for comfort brands that are familiar to them," at least initially, she says. But "health and wellness brands, now, have dramatically ticked up." Where the dust will settle remains an open question, but marketers in every category are rapidly thinking through how to ride the tailwinds of new consumer engagement or, in some cases, to correct course.

The evolving channel landscape is also shaping how manufacturers think about innovation. E-commerce was once a "nice to have." Now, in Spaulding's mind, it is a "must-win battle" for all consumer-goods companies. Retailers and manufacturers alike are evolving to reflect that imperative. "It completely changes how you think about innovation, about investment, about your relationships."

Manufacturers are left with open questions, says Spaulding. "How do you simplify the experience? How do you offer value to consumers? How do you evolve your products to address new occasions? COVID-19 has completely changed how you have to think about each of those. Where do you place your big bets?"

hard look at brands and packs that are most likely to succeed online and reevaluate the role that e-commerce can play in new product launches.[13]

Foodservice also presents challenges for consumer-goods manufacturers. For restaurants, this has meant evolving from the traditional foodservice focus to everything from groceries to destination shopping. Consumers, for their part, have been surprised to see local restaurants offering grocery boxes containing everything from personal-care products to artisanal home goods. They seem primed to continue seeking out this new form of distribution. Looking to fill the void created by the closing of so many restaurants, consumers have also purchased meals through grocery retailers.

Manufacturers must consider the role they can play in supporting this evolution of consumer needs. Cash-constrained operators looking to reduce waste and inventory will want their suppliers to provide more "bespoke" packages of raw ingredients that help manage cash flows. Restaurants optimizing their delivery services will look for ways to enhance the customer experience with new product formats of packaged accompaniments, such as single-use condiments. Others, particularly scale operators, may look to CPG companies for thought partnerships to raise sales of high-margin add-ons, particularly beverages. CPG companies have an opportunity to help consumers find what they need for today's reality.

3. Accelerate DTC evaluation and testing

In the face of the Great Recession, entrepreneurs successfully pivoted to generation-altering innovations—ideas ranging from online pure plays to the sharing economy. How will the collision of consumer behavior and technology during the COVID-19 pandemic set the stage for the next disruptors?

[13] Udo Kopka, Eldon Little, Jessica Moulton, René Schmutzler, and Patrick Simon, "What got us here won't get us there: A new model for the consumer goods industry, July 2020, McKinsey.com.

To weather the COVID-19 pandemic, many CPG companies stood up new ways of working in weeks—things that would normally have taken years.

The innovations have already started. Although 60 percent of CPG executives do not feel prepared to pursue DTC opportunities,[14] signs are emerging that many are taking bold steps—for instance, launching new DTC sites focusing on snacks, pantry items, condiments, and alternative meats, among other things. For some companies, particularly those in high-engagement categories with differentiated products, these offerings may very well stick in a commercially viable way. Certainly, that's what the companies launching them hope. For others, DTC forays will provide valuable direct connections to consumers, rich data, and opportunities to test and learn quickly.

The challenging economics of DTC persist, so while it should be on the agenda of every CPG leader, it requires a hard look. Customer-acquisition costs spiked before and during the pandemic and that is likely to persist. Given the high churn rates associated with the channel, its customer lifetime value—at gross margin—must cover that acquisition cost just to break even and must then reach approximately five times the acquisition cost for a DTC venture to scale up successfully.

To achieve this goal, CPG companies must consider DTC's full omnichannel value (sales, insights, testing); embrace a distinctive value proposition; focus deeply, from day one, on unit economics; and get ahead of the operating model and tech stack early to support scale if it can be reached. Given the many pieces that must fall into place, the right starting point will probably be an iterative venture capital–like model to surface insights rapidly, develop concepts, and build business cases. Further investment should follow only if the initial sprint yields promising results.

4. Harness new ways of working, including digital, to accelerate the development process

To weather the COVID-19 pandemic, many CPG companies stood up new ways of working in weeks—things that would normally have taken years. From restructuring teams to put them outside old reporting lines to implementing scenario-tested response plans, many CPG companies now have new proof points for how to operate an agile organization. These can now be leveraged to improve product development. The nerve centers that have buoyed operations during the pandemic can be carefully redeployed in the form of sprint teams focused on integrating consumer, competitive (including private-label), technological, and supply-chain insights. These teams can rapidly collide them to identify specific brand and product changes that meet consumer needs and preferences.

The evolving landscape also gives companies new opportunities to digitize their development process.

[14] McKinsey live poll during webinar "COVID-19: Implications and considerations for CPG e-commerce," June 2, 2020.

Use cases for digital can address the needs of employees and consumers alike. For R&D teams, digital tools can help track project portfolios and the critical drivers of business cases. This approach, which we call “assumption-based development,” dramatically improves a CPG company’s innovation performance. As projects progress toward commercialization, the rising prominence of e-commerce and, for some CPG companies, of their own DTC sites can enable and accelerate the test-and-learn process, to improve both speed to market and innovation outcomes.

Many CPG companies have already started to act. Some manufacturers have announced that they will trim their innovation pipelines by 50 percent or more to focus on the most promising projects. Others have rapidly launched DTC websites. Large brands are celebrating falling times to market—to just eight weeks, from a year. Yet many more companies are still flat-footed, wondering what to do. The race has already begun, and in the next normal, as in the Great Recession, companies that fail to innovate will probably be left behind.

Stacey Haas is a partner in McKinsey’s Detroit office; **Jon McClain** is an associate partner in the Washington, DC, office; **Paul McInerney** is a senior partner in the Tokyo office; and **Björn Timelin** is a senior partner in the London office.

The authors wish to thank Jordan Bar Am, Felicitas Jorge, Zachary Kubetz, and Erik Roth for their contributions to this article.

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