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Operations Practice

How retail can adapt supply chains to win in the next normal

Retailers in consumer discretionary categories were already struggling in the US before COVID-19. Better supply-chain management could be critical to their recovery.

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The US retail sector is facing one of the most challenging times in recent memory. For discretionary retailers, the headwinds are especially strong given considerable uncertainty driven by competitive dynamics, concerns over consumer confidence, and heightened demand for last-mile delivery.

It's increasingly clear the pandemic has materially changed US consumer behavior, perhaps permanently, with many retailers looking to alter their supply chains to compete in the next normal.

Major shifts in consumer behavior

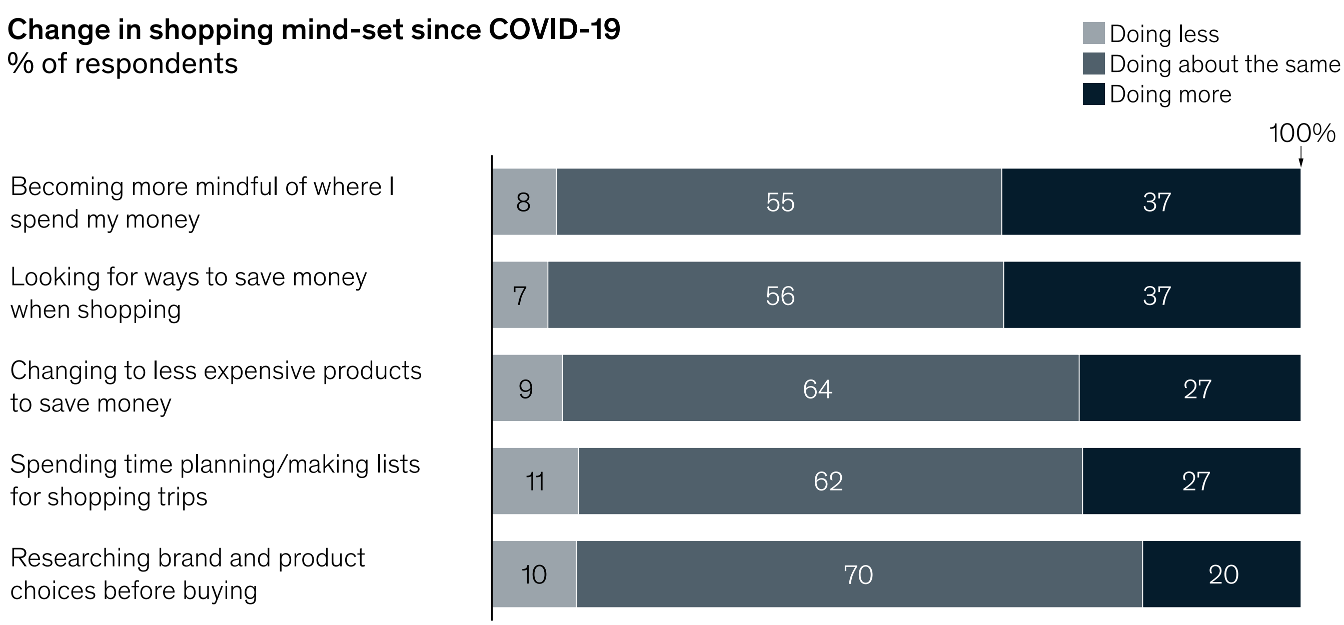
Our consumer sentiment survey from late September 2020 shows that more than half of US consumers are expect that the personal and financial impact from COVID-19 will last more than an additional four months. Not surprisingly, they also report becoming more mindful about how they're spending, looking for more ways to save money when shopping and taking steps to be more disciplined in their choices (Exhibit 1).

The survey also shows that consumer use of the online channel has increased for discretionary product categories. Consumers report that they expect to reduce many high-traffic, in-person activities in the future, including going to the mall. Given the social-distancing norms, consumers en masse embraced digitally enabled omnichannel fulfillment. For example, store curbside pickup has almost doubled compared to pre-coronavirus levels, while "buy online, pickup in-store" (BOPIS) has grown by almost 50 percent (Exhibit 2).

Online shopping of nondiscretionary items—through both conventional e-commerce

Exhibit 1

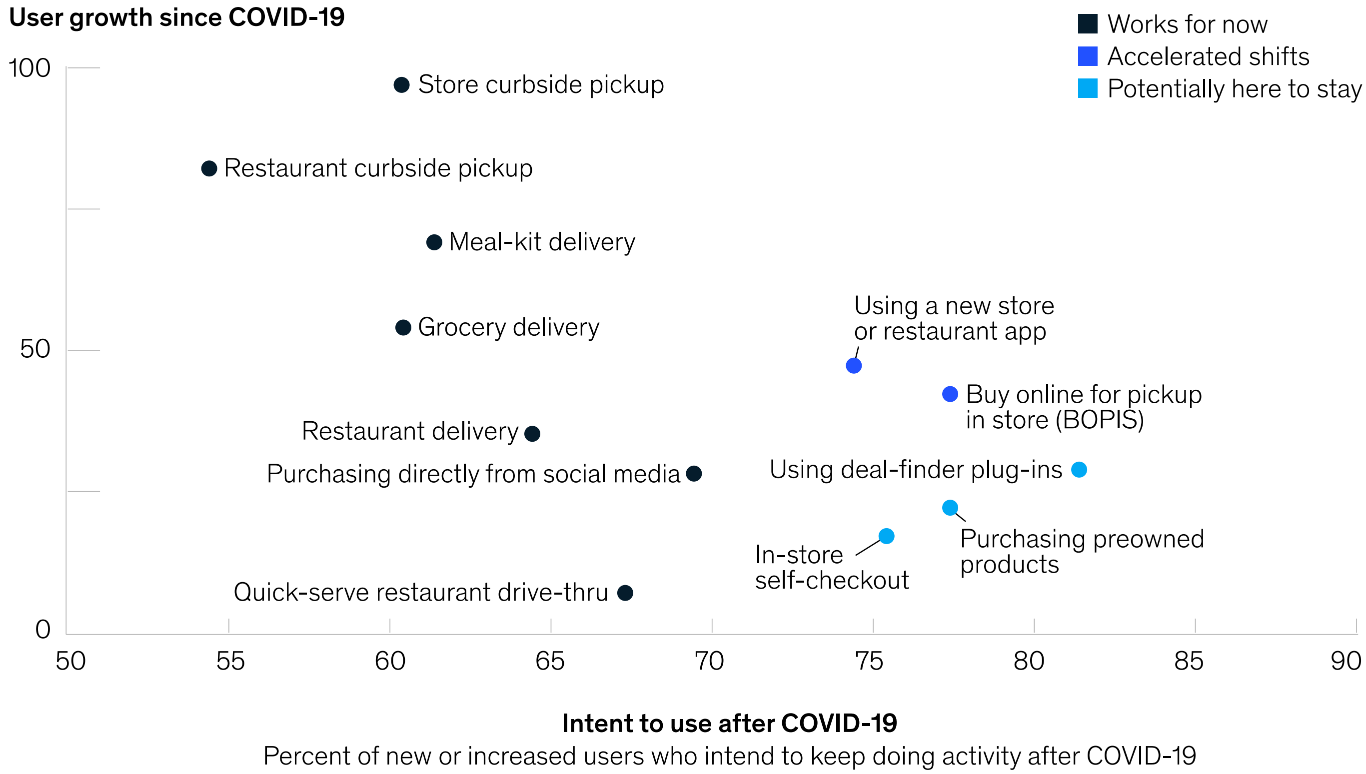
American are becoming more mindful of how they spend their money.



Source: McKinsey & Company COVID-19 US Consumer Pulse Survey 9/18–9/24/2020, n = 1,026, sampled and weighted to match the US general population 18+ years

Exhibit 2

Many consumers intend to continue newly acquired habits even after the crisis is over.



Source: McKinsey & Company COVID-19 US Consumer Pulse Survey 9/18–9/24/2020, n = 1,026, sampled and weighted to match the US general population 18+ years

channels, as well as new shopping channels with omnichannel fulfillment—seems poised to continue to grow post-COVID-19 as consumers become more comfortable about buying without trying products first in physical stores. Even for categories such as footwear, apparel, and home furnishings and appliances, 30 percent or more of US consumers now say they make most or all of their purchases online (Exhibit 3).

Supply-chain implications

Retailers have been planning for changes in consumers' expectations and online behavior, but they've generally assumed these changes would occur over a fairly long period of time. But COVID-19 has accelerated these changes almost overnight, leaving most retailers' supply chains unprepared to respond. As retailers look to the future, they will need to contend with consumers' expectation for seamless omnichannel fulfillment, as well as retailers' own increasing productivity pressures.

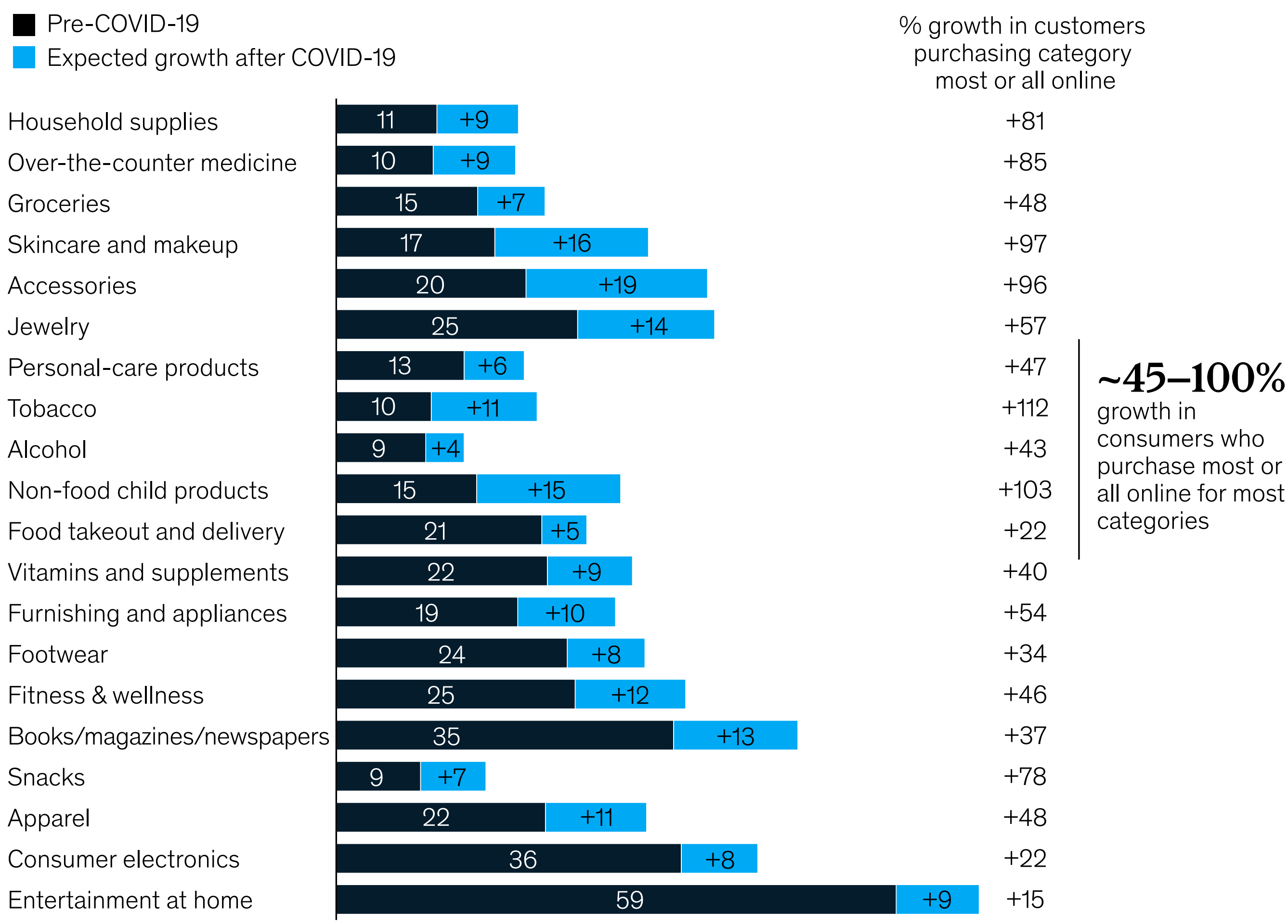
Robust omnichannel offerings have become table stakes

Physical distancing and stay-at-home mandates compelled retailers large and small to accelerate omnichannel initiatives (Exhibit 4). Most grocers and established players in discretionary retail, such as electronics sellers, department stores, and sporting-goods specialists, have accelerated the rollout of curbside pickup throughout their store network. Even mom-and-pop restaurants and stores have found creative ways to offer contactless, curbside pickup and omnichannel fulfilment. Moreover, higher willingness to purchase online (and to switch brands) is expected to intensify competition from single-

Exhibit 3

Many US consumers report planning to shift their purchases almost completely online.

Consumers' actual use of online channel before, and expected use after, COVID-19,
% of respondents purchasing most or all online



Source: McKinsey & Company COVID-19 US Consumer Pulse Survey 9/18–9/24/2020, n = 1,026, sampled and weighted to match the US general population 18+ years

brand, online-only retailers, which already have built e-commerce supply chains.

As omnichannel capabilities become essential, retailers can differentiate their customers' experience in various ways. This includes the speed of delivery (such as same-day or next-day); wider assortment and end-to-end visibility (such as giving a real-time view of inventory in the nearest store, as well as real-time orders and returns tracking); and a better experience (such as seamless orders and returns, easy personalization, and subscription services).

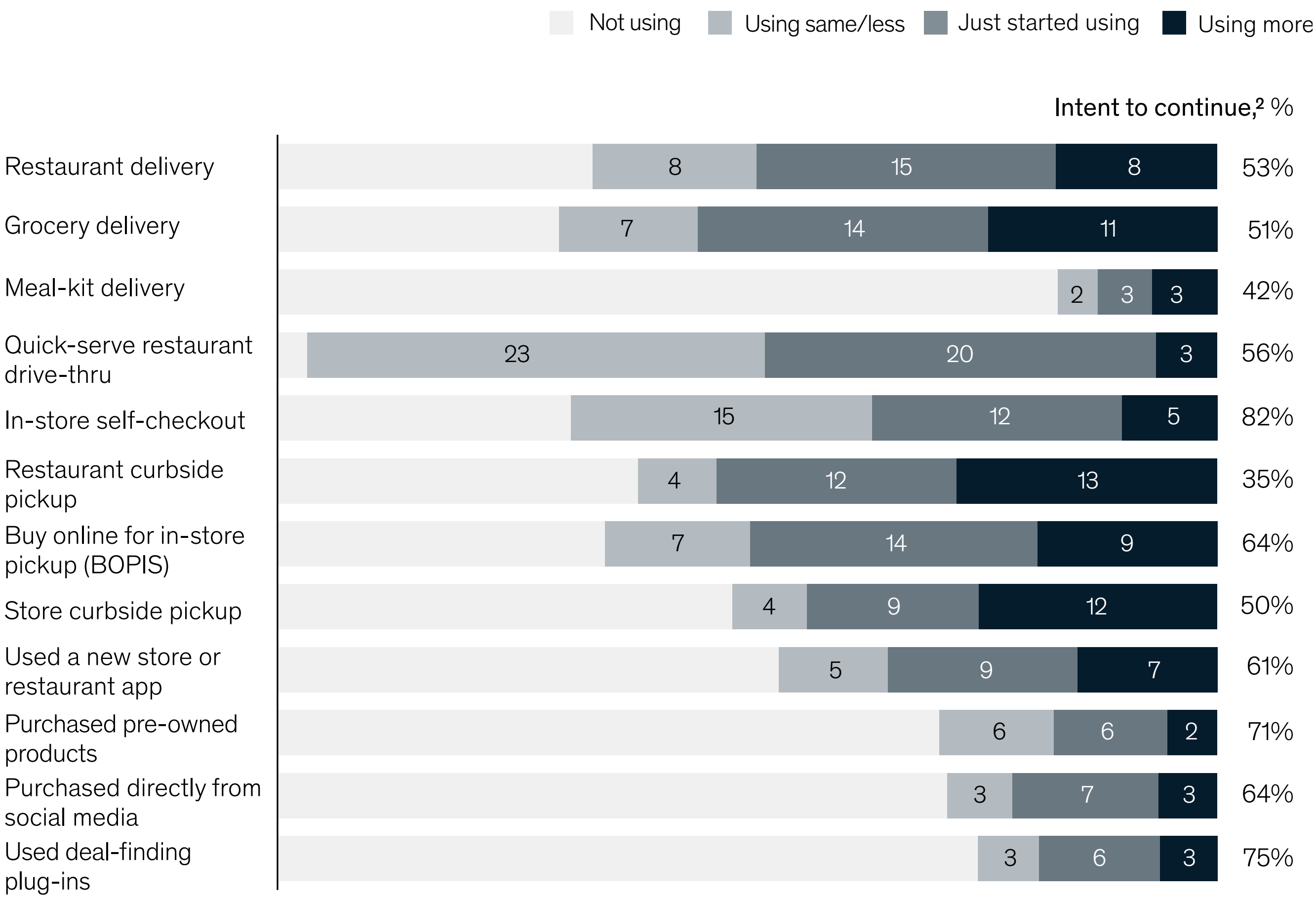
Productivity under pressure

Productivity pressures for many retailers are nothing new, as many have responded to rising e-commerce demand by getting more out of legacy infrastructure and systems. But for most players, e-commerce fulfillment is inherently

Exhibit 4

Use of digital and low-contact channels has grown markedly.

Have you used or done any of the following since COVID-19 started?
% of respondents



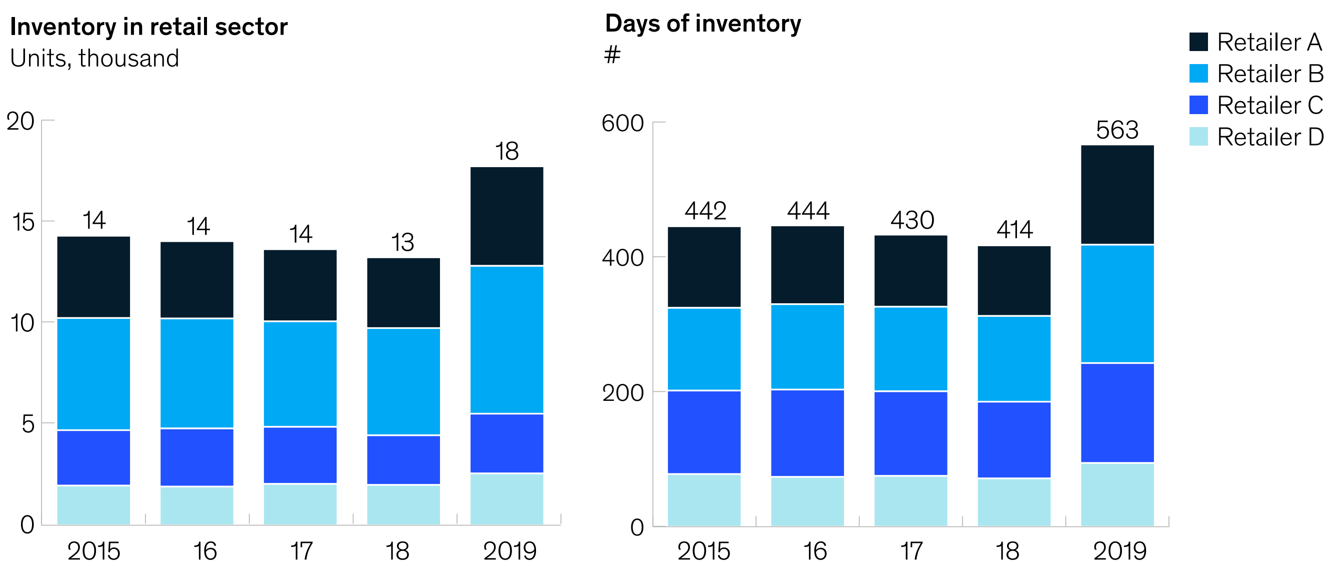
Source: McKinsey & Company COVID-19 US Consumer Pulse Survey 9/18–9/24/2020, n = 1,026, sampled and weighted to match the US general population 18+ years

more expensive than traditional brick-and-mortar logistics because more inventory must be held in the network—creating a barrier to the faster and more predictable service levels that consumers now expect.

To help address the combined challenges of fulfillment cost, service requirements, and productivity improvement, retailers have sought to keep inventories closer to consumption centers. In some cases, this practice has led to higher total inventory in the network. For example, the inventory-turnover ratio at most US department stores has decreased over the past five years. Unless countermeasures are taken, as e-commerce sales increase as a percentage of total sales, this trend may intensify—leading to higher capital requirements and increased markdowns if retailers are driven to sell off extra inventory at the end of the season (Exhibit 5).

Exhibit 5

Higher residual inventories often mean heavier discounting.



Some of the productivity loss could be offset by lower transportation rates depending on crude-oil prices. However, these transportation savings (and related factor-cost decreases) are likely a short-term benefit. Ultimately, retailers will likely need to look elsewhere for sustainable value capture, particularly in their supply chains.

Since the start of the pandemic crisis, most retailers have taken actions to address some of the short-term challenges (Exhibit 6). But only a few have truly set the foundations for the next normal, illustrated five strategic supply-chain imperatives.

Taking advantage of supply-chain opportunities

Those retailers that are thinking big and bold—taking a cleansheet view of their supply chains, making big strategic bets to reshape the supply chain's role in value creation—can position themselves to thrive over the long term. Creative problem solving that accepts constraints on capital availability as a given can help narrow the focus on finding flexible alternatives—and not just survive, but win.

Challenge each node's role in the supply chain
Retailers can start by thinking critically about the role of each node in their supply-chain network. Many, if not most, retailers have already started leveraging their store footprints for omnichannel fulfillment. Some have gone further—building state-of-the-art microfulfillment centers in metro areas, and converting portions of their stores as mini, in-region distribution centers (DCs) with faster delivery promise and faster fulfillment. All nodes in the network, including stores, distribution centers, deconsolidation centers, returns-processing centers, pop-up shops, and urban lockers, can be reassessed for their role. It's important that this comprehensive, rapid supply-chain analysis consider not only new demand profiles for the nodes owned by the retailer, but also how best to work with potential partners (such as local couriers and on-demand delivery players) to improve supply-chain performance.

Rethinking the role of all distribution nodes will likely prove essential in creating a sustainable omnichannel fulfillment model. For example, while most retailers have carried less inventory in their DCs by pushing product to stores, the result can be higher markdowns and unsold inventory. To

Exhibit 6

Checklist of actions using near-term levers

Omnichannel building block	Near-term actions (0–3 months)	Mid-term actions (3–6 months)
Customer-centric supply-chain model	Analyze the extent of shift in consumer sentiment and channel preferences to model demand in the new normal	Closely monitor seasonal demand shifts and refine forecasts
Network and ecosystem of the future	Identify quick-win opportunities to optimize product flows through nodes (eg, sending material directly from vendor to store or from import deconsolidation warehouse to store)	Repurpose stores either partially or fully to serve as fulfillment centers for e-commerce
End-to-end planning and information flow	Revise safety stocks and inventory-allocation algorithms to ensure enough stocks in digital channels	Quickly deploy bespoke advanced analytics tools to enable dynamic optimization of allocation, markdowns, and promotions based on new demand patterns
Omnichannel fulfillment and node operations	Reorganize distribution center (DC) operation schedules to preserve social distancing and other safety considerations Ensure enough staffing for increased e-commerce operations (eg, each-picking)	Improve visibility in DC operations by deploying digital performance management to indentify bottlenecks Accelerate automation improvements in conjunction with future network strategy
Omnichannell fulfillment—transportation and logistics services provider management	Conduct market events by factoring in changes to shipment volumes by lanes Partner with local delivery services (and gig-economy players) to improve service and cost economics for expected increased parcel volumes	Improve visibility and use dynamic routing optimization using real-time analytics to quickly respond to demand shifts
Digitization and process automation	Revew portfolio of digital investments that were put on hold to identify no-regreat digital initiatives for the next normal	Leverage bolt-on analytics tools to augment current digital and analytics capabilities with minimal investment
Operating model and change management	Embed safe working policies across the organization Rebalance roles and responsibilities to service increased demand in digital channels and the consequent higher use of analytics	Identify gaps in analytical and technical capabilities to redeploy and upskill employees across functions

solve this, some retailers are starting to use their port warehouses as temporary stocking points for imported products. These port warehouses could assume a greater role in pooling inventory upstream, so that retailers can push inventory to stores opportunistically rather in quantities too large for the stores' demand to absorb. A few retailers have considered repurposing stores to serve as fulfillment nodes for fast-moving products.

Embrace collaboration (even with competitors)
Retailers' survival and growth could depend in part on carefully considering which activities should be done in-house rather than outsourced. Historically, discretionary retailers have been shy of outsourcing logistics, fearing they might lose their ability to beat competitors to market. But the purported advantage was rarely worth the cost—and now the cost is simply too great. Moreover, new technologies and business models mean that retailers can have more visibility (and even control) over outsourced logistics than they had when running everything themselves.

With the need to preserve cash, retailers could explore partnerships with each other—or with third-party logistics (3PL) companies, real-estate or warehouse providers, or fourth-party logistics providers that take over management of even more of the supply chain. For example, noncompeting retailers could enter into a consortium-like partnership to use each other's distribution nodes, or a common 3PL provider to achieve wider geographical reach with little additional capex. These could help companies deleverage their balance sheets while improving service and lowering costs—but it would likely require them to adopt a more collaborate stance in partnering with 3PLs, rather than viewing them merely as transactional providers.

Build resilience in the supply chain
COVID-19 has demonstrated how important it is to have resilient supply chains that can adapt quickly and continue to deliver during times of disruption. Building resilience is a matter of establishing contingencies, engaging in flexible resource planning, and (in some cases) adding redundancy for critical products in the system.

Part of being resilient is building an agile network of suppliers and partners. Certain major nondiscretionary retailers are diversifying their supply chains to mitigate dependencies on geographically concentrated suppliers. Retailers dependent on offshore production might explore alternative sources and locations, perhaps developing manufacturing capacity closer to core markets. Rethinking production footprints could help drive down risk while providing new value propositions for product that are sourced or made locally.

Focus on rapidly deployable bespoke analytics
Retailers have historically forecast demand based on sales in prior years. The current crisis has upended the underlying assumptions, rendering these historical statistics less effective. The inability to predict demand has a snowball effect on a retailer's ability to hold the right amount of inventory, plan seasonal merchandise, and avoid unnecessary markdowns.

In response, retailers can deploy advanced analytics for forecasting, as well as for assortment and allocation decisions based on emerging market trends. But the answer is not necessarily to deploy expensive analytics systems; instead, retailers could explore bespoke, plug-and-play solutions that use their existing systems while providing a more credible view of demand trends—and the optimal inventories at each node. A few large retailers, for example, have deployed advanced analytics to segregate the impact of pantry loading so that they can better estimate the sustained demand increase that's critical for improved demand forecasting.

Prioritize end-to-end visibility, achieved through simplicity
Visibility into strategic and tactical actions and their impact on service, cost, and capital is vital in this dynamic environment. Retailers can quickly (and inexpensively) deploy a supply-chain control tower to orchestrate actions across different functions and improve end-to-end visibility in responding quickly to emerging trends.

Multiple grocery retailers have deployed supply-chain control towers within four to six weeks, achieving significant benefits from real-time visibility. These chains have responded to unprecedented demand swings by quickly reallocating inventories, analyzing and de-bottlenecking warehouse operations, and rebalancing timing of vendor contracts. They've achieved such end-to-end visibility and responsiveness by using relatively simple tools linked to existing data streams and requiring little or no capital expenditure.

Retailers with the most robust growth over the past decade have often done so by prioritizing supply-chain optimization. That makes sense, because a supply-chain strategy focuses on the sustainable creation of value for the retailer, the customer, and the broader community. Five strategic moves led by the supply-chain organization might prove to be the most critical factors to win in the next normal.

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