

# THE FUTURE OF ONLINE GROCERY

THREATS AND OPPORTUNITIES



“A modest efficiency improvement of 10% by US online retailers would mean **70%** of the population could be served profitably by an online-only grocer with less than **7%** market share.”

# THE FUTURE OF ONLINE GROCERY

*Food retail has always been a tough business. Today's major grocery chains have all weathered repeated attacks from new competitors and new formats, and are always looking out for the next wave of competitive threats. Online grocery retail is such a wave, and we believe that it will be economically viable in more markets than most people think – and sooner than they think. Just as with past waves of new competition, the best operators will adapt, survive, and thrive. To meet the online threat, established retailers will need to upgrade their business's capabilities – and those that succeed can gain at the expense of less well-prepared rivals.*

Although online shopping has long threatened bricks-and-mortar retailers in other sectors, so far it has had less impact on food retailers. But this is changing – online grocery is coming of age. Online grocers have already captured 6% of the market in the UK, largely driven by online offerings from all major bricks-and-mortar players as well as a maturing offering from online-only player Ocado. Although online grocers currently have a smaller share of markets such as the US and Germany, they are growing steadily, and there are credible signs that major players such as AmazonFresh and Walmart are ready to invest rapidly to accelerate this growth.

You may be sitting there thinking that online doesn't *really* work in grocery, the economics don't add up, so you will be safe. That is not the case. Or you may be sitting there thinking that your market has already reacted to the online threat, and the major disruption has already happened. That is also not the case.

In this paper we assess the likely impact of e-commerce on the grocery market: where it is likely profitable, what it means for bricks-and-mortar food retailers, and how they should respond.

# WHERE CAN ONLINE-ONLY GROCERS BE PROFITABLE?

Around the world a variety of online-only grocers have popped up, including Ocado (in parts of the UK), FreshDirect (in parts of the East Coast US) and Peapod (in the Midwest and East Coast US). Some of these companies have been in business for more than 25 years, so while this is not a new model, there has been considerable growth in the past five years – with Ocado reaching profitability and AmazonFresh signaling the start of a wave of massive expansion. These are signs that this format is moving from a niche offering to something with both staying power and the power to shape the industry.

Of course, the online-only grocery business is challenging. Capital requirements, delivery costs, fulfillment costs, and price transparency are all high. Customer spend can be lower because of less impulse buying. Many customers resist the idea of having someone else pick fresh food for their family, while others have “need it now” shopping patterns. Profitability is only possible with scale, and for many years barriers to entry were high. Most companies with the capital and the know-how to build an online grocery business are already in the structurally - advantaged bricks-and-mortar grocery business. In some concentrated, mature markets, retailers have had to enter the game after competitors have turned to online to try and gain an otherwise elusive competitive advantage. However, in many markets, the bricks-and-mortar retailers have had little incentive to pioneer a less profitable format that would cannibalize their existing sales.

But with customer demand for online grocery shopping steadily increasing, online-only players have been stepping up to meet it – increasing the incentive for bricks-and-mortar grocers to enter the online business as well.

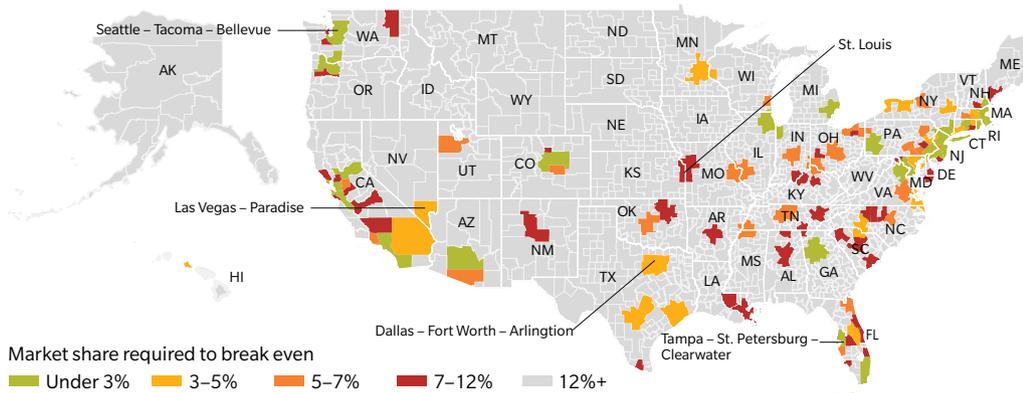
How far online grocery grows will ultimately depend on where it is financially viable. By looking at the economics of a range of existing online grocers, we have modeled what it takes to achieve financial success as an online-only grocer. We believe that in many parts of the world, online grocers can be profitable with lower market shares than those that have already been achieved in the UK.

Fundamentally, the market share required to break even depends on:

- Population density – affects cost of the “last mile” delivery
- Overall population – affects fixed asset leverage
- Market price levels – determine achievable gross margins

Taking the economics of best-in-class online grocers as a baseline, we have modeled how these factors influence the viability of a range of grocery markets. Exhibit 1 shows the results for the US. If anything, this gives us a conservative view on the viability of markets, as there are clear ways online-only retailers can boost their economics. For example, a company like Amazon can gain a real advantage from attachment purchases from its non-food assortment. And all operators have the option of adding click-and-collect points to potentially reduce delivery costs, a topic discussed in the section “The Opportunity: Competing in the Online Grocery Business.”

Exhibit 1: Market share required to break even for a pure-play online grocer



The three example markets in Exhibit 2 illustrate the trade-offs at work. Both the Tampa Metropolitan Statistical Area (MSA) and the St. Louis MSA have large populations and relatively low market price levels, but St. Louis has much lower population density and a small market price disadvantage. So despite their superficial similarity, the resulting margin to break even is considerably different. Las Vegas has a lower population level, slightly lower population density, but a high market price level – resulting in a lower breakeven market share.

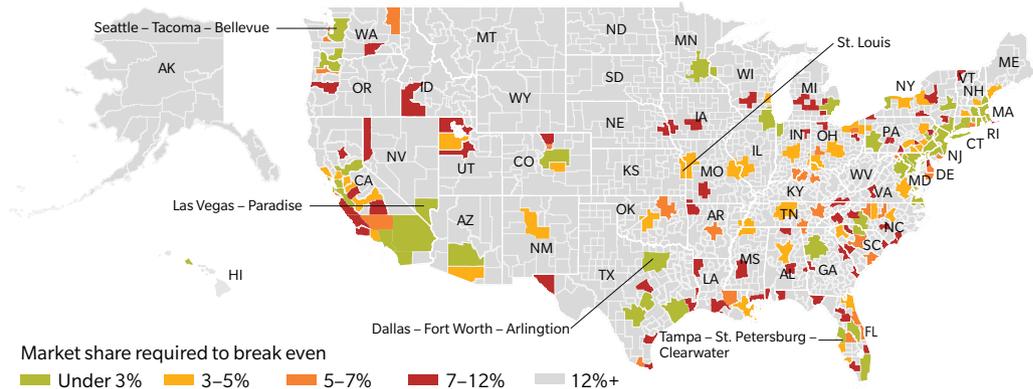
When we apply this calculation to more densely populated European countries, we see an even more attractive market for home delivery. For example, with today’s economics, about 60% of the German market can be served profitably.

Exhibit 2: Comparing three market areas with different characteristics

MARKET	POPULATION	POPULATION DENSITY	MARKET PRICE LEVEL	RESULTING MARGIN REQUIRED TO BREAK EVEN
Tampa – St. Petersburg – Clearwater	2.7 MM	High	Low	Under 3%
Las Vegas – Paradise	1.9 MM	Medium	High	3-5%
St. Louis	2.7 MM	Medium	Very low	5-7%

If online grocers continue to become more efficient – not unlikely, since the format is still relatively new – it will open up more markets where they can break even. Exhibit 3 shows how even a modest efficiency improvement of 10% would significantly increase the proportion of the US population that could profitably be served by online grocers. In this scenario – which we believe is a plausible “central case” – 70% of the US population could be served profitably by an online only grocer with less than 7% market share.

Exhibit 3: Market share required to break even after 10% efficiency improvement



Of course, the online retailers' own economics are only part of the story. In any given market, how large a share they capture is also affected by inherent characteristics – such as the age distribution of the population and the adoption of online tools for other commerce. But these are likely to be minor (and diminishing) constraints upon online retailers' growth, based on the fact that market share in the UK is at about 6% (which, although split across many different players, shows the attractiveness of online offerings to customers) and is still showing signs of growth – with significantly higher share in some of the more densely populated regions. On the other hand, what established retailers do will make more of a difference: If bricks-and-mortar retailers can deliver better value or a better experience, things will be much tougher for the online grocers.

Given these dynamics, **retailers who enter the online business first and target the most attractive markets can have a serious advantage and make it much harder for those who set up online operations later.** In markets such as the UK and France, where online business models have taken off, late bricks-and-mortar entrants are finding it difficult to get traction and are being forced to try creative things to jumpstart their efforts – such as Morrisons' partnership with Ocado.

This is not to say that new online-only entrants can't still disrupt markets like the UK and France. There are big differences between the likes of Amazon and Google entering the market and a late-entrant bricks-and-mortar player trying to get in the game. Amazon and Google can afford to play a much longer, lower-margin game. And their economics can look very different: either through the support of attachment purchases, as is the case with AmazonFresh, or through an innovative new model, as used by Google Shopping Express.

For a bricks-and-mortar retailer, these dynamics present both a threat to the existing business and an opportunity for a new source of growth and differentiation.

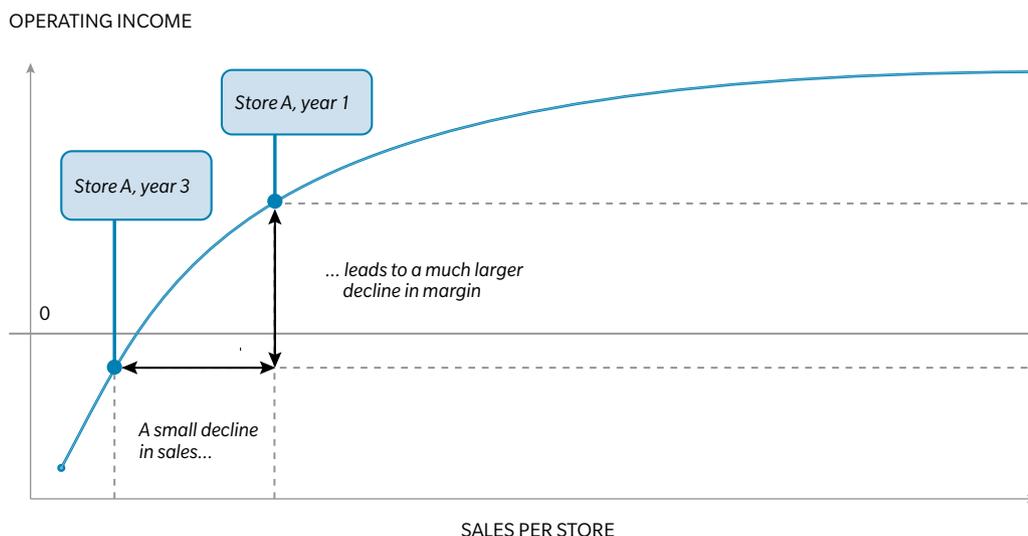
# THE THREAT: IMPLICATIONS FOR BRICKS-AND-MORTAR GROCERY

Online grocery poses a threat to established grocers everywhere, but the exact nature of the threat varies from one market to another. In some, online-only home delivery options may capture a large part of the market; in others, bricks-and-mortar grocers may move and establish a mix of click-and-collect and delivery models. Either way, bricks-and-mortar grocers will feel a significant financial impact, as their slender margins make them sensitive to even a small loss in market share. For a traditional grocer with 2% EBIT and a 20% volume variable margin, a 10% loss in share to online would destroy all of its profit. Even a 5% share would be disruptive, and online grocery is already at 6% in the UK.

But this does not spell the end for bricks-and-mortar stores and, in fact, the stores that survive are likely to be more profitable than the average store today. Being one of the bricks-and-mortar grocers that survives will not be about beating online formats (although that can of course help). Instead, it will be about each store winning local competitive battles to be the last store standing in a given area. In other words, you don't have to outrun the bear – you just have to outrun the person standing next to you.

Whether online grocery is already taking hold in your market (as is the case in the UK and France) or is in the early stages of growth (as in the US and Germany), the first step for bricks-and-mortar retailers is to recognize that this will inevitably mean a net loss of sales through their traditional bricks-and-mortar grocery channel. High operational gearing means that as stores lose sales, income will decrease by much more in percentage terms. The implication is that some – perhaps many – individual stores will actually become unprofitable. Exhibit 4 illustrates the effect of declining sales per store on operating income.

Exhibit 4: The impact of falling sales on a company's operating income



This means that bricks-and-mortar retailers will need to close unprofitable stores. Some of the sales lost through these closures will be clawed back by the remaining bricks-and-mortar estate, making the remaining stores more profitable and better able to weather the channel shift. However, many of these sales will end up with other formats or channels. The exact impact of that channel shift depends on the way retailers respond. If retailers try to maximize their cash profit, the impact could be very dramatic. If instead they just try to stay profitable at a similar rate, they could keep open most of their stores. In a middle scenario at steady state, we expect that an online market share of about 8% would ultimately mean that up to 30% of bricks-and-mortar square footage would close in most of the geographies we have modeled. We think two key patterns will emerge as a result: an increase in the disparity between the best and the worst sites, and greater challenges to winning customers with a traditional full-assortment grocery proposition.

## LOCATION, LOCATION, LOCATION

The rise of online grocery retail will accentuate the disparity between the best and the worst sites. Poor locations will close, while strong locations will benefit from clawing back some of the sales from store consolidation. The challenge will be to beat local competition: The last stores left standing in each area will gain more sales from competitors that close than they lose to online. So now is an opportune time to re-think the real estate portfolio, assessing each store on the battles it is fighting and the attractiveness of the natural customer base it is serving. At the simplest level, stores will fall into three categories:

1. **Stores that cannot be saved**, where you should minimize your investments, harvest cash where possible, maximize the chance that sales are clawed back in your other locations, and reduce exit costs
2. **Stores that will survive** in a base case scenario, where you should maintain and protect your leading position but not over-invest
3. **Stores whose destiny can be changed**, where you should concentrate your investment in the elements of the customer proposition most likely to give the store a chance to beat its local competition

## ACCELERATION OF THE COLLAPSE OF THE MIDDLE

Traditional middle-of-the-road grocers have always been fighting a war on two fronts. They face competition from both sides of the customer value proposition: Price leaders beat them with lower everyday prices underpinned by lower-cost formats, while quality leaders beat them with premium products and services that are too costly for a traditional grocer to deliver. This “collapse of the middle” is a constant struggle for traditional grocers who have to balance pricing and quality (by which we mean all aspects of choice, service, and freshness) to win customers in their local area.

The growth of online formats will make things even tougher. Price leaders will still have a cost advantage over online formats, and the resulting price advantage will keep most of their customer base loyal. This could be disrupted if AmazonFresh or Google go for an aggressively priced offer in a market, as they have the business model to support lower margins for longer than traditional grocers and so could undermine price leaders’ advantages. However, this has not been how they have attacked the US market so far; AmazonFresh is typically priced above traditional grocers.

Quality leaders will also still drive traffic with the unique services and products they have available. But the traditional supermarkets will be most at risk, with online grocers picking off some of their best, least price-sensitive customers.

Fighting the collapse of the middle is about both reducing the share of your customers you lose to online and beating the other competitors in your format.

1. **Price leaders** should protect their leadership position, cutting costs and plowing savings into better value for customers. The more aggressive they are about ruthlessly lowering costs, the more protected they will be against a play by Amazon or Google.
2. **Quality leaders** should focus on the elements of their offer that differentiate them both from online and traditional grocers. This means driving assortment innovation, leading on fresh, and adding or growing services that drive traffic.
3. **Traditional grocers** must first focus on winning against all other traditional grocer competition in their market through a price position that is in touch with the leaders and a shopping experience that is differentiated from lower cost options. This means constantly finding sources of savings to invest in deep customer relationships, lower prices, sharper promotions, better quality, better service – wherever the returns are highest.

## SURVIVING AND THRIVING

Bricks-and-mortar retailers who can right-size their store estates while improving their customer proposition and capture share from their traditional rivals can do more than just survive – they can thrive. Even once online retailers have grown large enough to disrupt the business model of bricks-and-mortar grocers, the latter will still account for the vast majority of grocery shopping: The best, most agile operators can gain more from flat-footed traditional competitors than they can lose to e-commerce. We expect to see higher profitability in the stores that survive, especially in markets that are over-served today.

## THE OPPORTUNITY: COMPETING IN THE ONLINE GROCERY BUSINESS

As a bricks-and-mortar grocer, in addition to the threat posed by online grocery, there is also an opportunity to reach new customers and grow sales through this format. Your current assets and know-how give you an advantage to seize this opportunity rapidly. If you aren't already running an online channel, we believe you should be thinking seriously about your options. And if you are already active in this channel, you should be thinking about how to evolve your offer and defend against future disruptive forces, such as the internet giants making a play in your market.

If online grocery is not yet established in your market, it is absolutely true that taking some of your business online will cannibalize more profitable sales in your bricks-and-mortar stores. But since online is a model that can be profitable in many markets, it is fair to assume that *someone* will soon be serving those markets. For established players, the choice is losing profitable bricks-and-mortar sales to someone else, or to their own online operation. Choosing to delay will make entry more difficult, risky, and expensive, as late movers in France and the UK are finding.

Of course, this is not straightforward: Online grocery is still a young format even in the most mature markets, and there's no tried-and-tested blueprint for success. Any retailer looking to enter online grocery first needs to answer some fundamental questions, which we will discuss in turn:

- When is the right time to launch, invest in, or aggressively expand an online format?
- What is the right balance between click-and-collect and home delivery – and how can I influence this?
- What is the most financially viable way to fulfill orders, and how should that evolve over time?

## WHEN IS THE RIGHT TIME TO LAUNCH, INVEST IN, OR AGGRESSIVELY EXPAND AN ONLINE FORMAT?

The right time to launch depends on your market, and a key consideration is that the economics of online grocery require rapidly reaching scale in order to be successful.

The advantages conferred by scale make the financial benefit from moving first very significant. As you look at your portfolio of assets and the markets they cover, start by looking at the places where you have a chance to be a first mover. If you are in a mature market such as the UK or France, there may be no place where this is possible. However, if there is not already a dominant player in your market, investing first is likely to deliver a better return on investment.

When planning the roll-out of an online business, the focus should be on driving full utilization from all of your fixed costs, such as distribution centers, delivery fleets, and marketing spend. This means a plan that concentrates on winning relatively high market share in geographically concentrated areas before expanding to nearby areas – and that requires investment ahead of growth. You may also want to over-invest in delivering a high-quality service experience to ensure customer trial turns into customer acquisition even while you are still working out some of the kinks in your processes.

## WHAT IS THE RIGHT BALANCE BETWEEN CLICK-AND-COLLECT AND HOME DELIVERY – AND HOW CAN I INFLUENCE THIS?

Exhibit 5 shows the different models that online grocery retailers and third parties have employed so far. In some markets, one of these models has already become dominant. In France, click-and-collect has significant traction with customers. In other markets, such as the UK, customers generally expect both options. If you operate in a market with a clearly dominant customer model, you will have to either follow that model or recognize the risks of trying to break from the pack. Even in markets where one model or the other is dominant, there may be opportunities to push multiple customer fulfillment models. Either way, if you choose to focus on a fulfillment model (or mix of models) that is different from the dominant model in your market, you will need to think carefully about the rest of your customer proposition to ensure you give customers a reason to follow your choice.

## Exhibit 5: Different models for online grocery retail

	DETAILS	WHO TYPICALLY DOES THIS
<b>Picking: In store, by retailer</b>	<ul style="list-style-type: none"> <li>Retail employees pick orders directly from the shelves</li> <li>Orders typically picked from a store near delivery address</li> </ul>	<ul style="list-style-type: none"> <li>Bricks-and-mortar retailers, especially at launch, e.g., Tesco UK at launch</li> </ul>
<b>Picking: In store, by third party</b>	<ul style="list-style-type: none"> <li>Individuals contracted through a third party pick orders directly from the shelves, just as an in-store customer would</li> </ul>	<ul style="list-style-type: none"> <li>Technology based start-ups, e.g., Instacart</li> </ul>
<b>Picking: From warehouse or dark stores</b>	<ul style="list-style-type: none"> <li>Orders picked from purpose build warehouses or dark stores</li> <li>Dark stores are essentially warehouses that are laid out more like stores, complete with shelf replenishment processes</li> <li>Automation is generally higher in warehouses, although the two are converging</li> </ul>	<ul style="list-style-type: none"> <li>Online-only retailers, e.g., FreshDirect</li> <li>Many bricks-and-mortar retailers add dark stores to in-store picking as online business grows, e.g., Tesco UK</li> <li>Some bricks-and-mortar stores use third-party warehouses from the beginning to minimize upfront investment yet take advantage of picking efficiencies, e.g., Morrisons</li> </ul>
<b>Delivery: Click-and-collect</b>	<ul style="list-style-type: none"> <li>Customer collects pre-picked order from a collection point</li> <li>Collection point may or may not be attached to a store</li> <li>Increasing range of collection points (e.g., refrigerated lockers at an airport in the UK)</li> </ul>	<ul style="list-style-type: none"> <li>Bricks-and-mortar retailers, especially in France and the UK, e.g., Auchan</li> </ul>
<b>Delivery: By retailer</b>	<ul style="list-style-type: none"> <li>Retailer has own fleet of vans and delivery drivers</li> <li>Order is driven to the customer</li> </ul>	<ul style="list-style-type: none"> <li>Bricks-and-mortar retailers and online-only retailers, e.g., AmazonFresh</li> </ul>
<b>Delivery: By third party</b>	<ul style="list-style-type: none"> <li>Third party may be a traditional logistics company, a dedicated grocery delivery service, or contracted individuals</li> </ul>	<ul style="list-style-type: none"> <li>Mostly when picking is also done by (the same) third party, e.g., Instacart</li> <li>Retailers focused on ambient groceries (e.g., Amazon, not AmazonFresh) may send via traditional courier services</li> </ul>

However, there are large markets – such as the US and Germany – where no model has gained enough traction to be called dominant. If you are in one of these markets, you have the chance to shape the model that will be dominant, at least for a while. In that case, you should carefully examine the economics of each option from two angles:

- **The additional gross margin the model will allow you to generate:** Generally, customers have shown a willingness to pay for home delivery and lower price awareness on product prices for delivery options. With click-and-collect options, we have seen that customers expect the same prices as in stores and no delivery fee. Home delivery may therefore allow you to generate a higher gross margin.
- **The fulfillment and delivery costs of each model:** Generally, a click-and-collect model will reduce your delivery costs but not your fulfillment costs. The extent of the reduction depends on how dispersed your click-and-collect points have to be to meet customer expectations. If you can use stores as your only click-and-collect points and take advantage of existing deliveries to those stores, the delivery cost could fall nearly to zero. By contrast, if you have to rent or buy click-and-collect points, refrigerate them, and place them at every mile, the delivery costs may not be significantly reduced.

These dynamics create a trade-off. Where you can generate enough additional gross margin to offset increased delivery costs, home delivery models have the advantage. Home delivery may even allow you to reach profit levels that are similar to bricks-and-mortar profit as your supply chain becomes more efficient. Where price parity with bricks-and-mortar grocers is expected and customers aren't prepared to pay charges that reflect the true cost of delivery, a click-and-collect model is best – although the higher costs involved mean that long-term profit will always be lower than a bricks-and-mortar model.

In markets where customers expect both options, you may choose to use incentives such as price, assortment, or service levels to manage the mix of customers who utilize each option. In that case, it is important to balance the cost of the incentives with the two factors discussed above to determine the optimal strategy for your markets.

## WHAT IS THE MOST FINANCIALLY VIABLE WAY TO FULFILL ORDERS, AND HOW SHOULD THAT EVOLVE OVER TIME?

Looking at the evolution of online players such as Ocado and Peapod, we believe that sustaining long-term profitability requires picking orders from purpose-built facilities with high degrees of automation. This is true for both click-and-collect and home delivery models. That said, there are two reasons to consider fulfilling orders through your stores:

- 1. Capital:** In the short term, fulfilling from stores allows you to build up a customer base before investing in an expensive fixed asset – giving you time to learn about what your customers buy, how they shop, and what level of service they demand. This knowledge can then help you make a more efficient and effective investment of capital when you build your warehouse.
- 2. Speed to customer:** Models such as Instacart use the ability to get an order to a customer in a few hours as a major selling point, and they charge for the service. Being able to fulfill rush orders in stores may allow you to generate enough additional revenue to cover the inefficiencies.

As you grow, you may have a hybrid fulfillment model. You may choose to build a facility to serve areas where you have already established and grown your online business but use stores as fulfillment centers in potential growth areas. This allows you to grow quickly and test the waters in new potential markets before investing in the capital assets. You may also choose to maintain the capability to pick orders in stores for express deliveries – or even partner with a third party (e.g., Instacart in the US) to fulfill this type of order. As your model begins to stabilize, driving sustainable profitability will mean ruthlessly grinding costs out of fulfillment.

## CONCLUDING REMARKS

Though online grocery has been around for years, it is only now starting to gain traction in major markets. Our analysis suggests these formats can be profitable in much of the US and Western Europe. Their evolution in France and the UK shows how fast they can grow, and now major players such as AmazonFresh are investing heavily in the US and Germany. Even in markets where online grocery is relatively mature, new and well-capitalized entrants could make a significant impact.

The growth of this format does not mean the end of bricks-and-mortar grocery, but it will be highly disruptive. As established players lose market share, stores will need to close, while in many cases the stores that remain may become more profitable than before as local rivals disappear. Bricks-and-mortar grocers therefore should focus not on outrunning the “bear” of online grocery but rather on outrunning the person next to them, their local competition.

Although online grocery certainly poses a threat to a bricks-and-mortar grocer, it also presents an opportunity. Bricks-and-mortar grocers have assets, brands, and expertise that can be used to launch an online business more rapidly than an online-only player. While entering the online business is clearly risky, it can also allow an established retailer to reach new customers, serve different purchase occasions, and increase loyalty. Bricks-and-mortar stores should carefully consider the opportunity to start, grow, and upgrade their online offerings to take advantage.

“Traditional supermarkets will be most at risk from online grocers picking off some of their best, least price-sensitive customers.”

## ABOUT OLIVER WYMAN

Oliver Wyman is a global leader in management consulting that combines deep industry knowledge with specialized expertise in strategy, operations, risk management, and organization transformation.

In the Retail practice, we draw on unrivalled customer and strategic insight and state-of-the-art analytical techniques to deliver better results for our clients. We understand what it takes to win in retail: an obsession with serving the customer, constant dedication to better execution, and a relentless drive to improve capabilities. We believe our hands-on approach to making change happen is truly unique – and over the last 20 years, we've built our business by helping retailers build theirs.

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