THE CHALLENGES OF ONLINE GROCERY

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On Friday, November 3, 2017, Amazon Fresh customers in "select zip codes" across the US received the news that their delivery service would be terminated. Jack O'Leary of Planet Retail RNG noted, "AmazonFresh has always been an economically challenging program to operate without scale," and, "That scale is tough to reach in many areas."[1] Rival services such as Peapod and Instacart have encountered similar struggles to date. In fact, Peapod was only profitable in three of its 12 markets in 2016 and, on a recent conference call, Jeff Carr, the CFO of Peapod's parent company Ahold Delhaize, remarked, "We're not happy with Peapod's performance, but we feel confident we'll be able to improve that performance."[2, 3] Meanwhile, Instacart, which delivers groceries from a network of independent physical stores, is "unit profitable" in ten of their 19 markets, meaning that an average order is profitable in ten markets and unprofitable in the other nine.[4] This is before overhead expenses such as corporate administration, marketing, and R&D, which means that the business loses money overall.[5]

What makes the economics of grocery delivery so challenging? The answer lies at the level of the individual order. For each unit of grocery product sold, there are costs inherent in the delivery business model that do not exist for conventional grocery retailers or even for non-grocery online retailers. A 2014 Strategy& study on the European market concluded that supply-chain costs for delivery of a typical online order were 13% higher as a result of complexities such as added warehousing capacity requirements, delivery time and expense, and the logistics of order assembly.[6] Furthermore, capital requirements for online grocery are significantly higher than for other e-commerce business models because of the need to invest in expensive perishables equipment and facilities, which raises ongoing maintenance and replacement expenses.[7] In general, grocery is "a really low-margin business," according to Bloomberg's Ellen Huet. She elaborates that once the higher cost structure is accounted for, "...it's unclear where the margin comes from."[8]

COMPOSITION OF ADDED COSTS OF ONLINE GROCERY

(% OF TOTAL) Cost Driver	Grocery Store Curbside Pickup	Home Delivery From Warehouse	Mailed Meal Kit Service
Added Warehousing		14.0%	11.2%
Store Shopping Labor	28.9%		
Order Assembly Expenses			50.4%
Home Delivery Expenses		39.5%	
Other Expenses	71.1%	46.5%	38.4%

Source: Sinha, Amithabh and Paul Weitzel. "eCommerce Supply Chain Insights in Groceries and Consumer Packaged Goods in the United States February 2015." Technology and Operations Department. Ross School of Business, University of Michigan. February 2015.

We can draw two important conclusions from this picture of unit economics. First, in order for the online grocery delivery business to be profitable, it must take place in high-population, high-density urban areas. This type of model both minimizes the costs of "last mile" delivery by reducing drive times between deliveries, and increases utilization of fixed assets such as warehouses and delivery vehicles. That said, a study by Oliver Wyman determined that while a number of major US markets fit these criteria, an online grocer would still need to achieve a critical market share in order to attain profitability.[9] Second, within these markets, online grocery businesses would benefit from leveraging pre-existing networks of brick-and-mortar grocery stores in order to improve the fundamental economics of their business model.

Two main ways that grocery retailers are providing a platform for e-commerce grocery initiatives are through their own meal kit services and through click-and-collect offerings. A recent article in Forbes argued that traditional grocery businesses have a fundamental cost advantage over the meal kit businesses (e.g. Hello Fresh; Blue Apron) due to their established nationwide food supply chains, and thus would compete effectively in this space.[10] Curbside pickup services, for their part, leverage both consumer desire for convenience and the lean economics of traditional grocery stores. Among traditional grocery businesses, Albertsons is leading the way on both fronts, having recently purchased leading meal kit service Plated and announced plans to grow its click-and-collect offerings to 200 stores by the end of fiscal year 2018.[11] O'Leary of Planet Retail called click-and-collect services "hugely relevant" and speculated that Amazon would pursue a similar strategy with Whole Foods.[12]

These initiatives by Albertsons and Amazon are a harbinger for change in the food industry overall, as connections between brick-and-mortar grocery and e-commerce continue to grow stronger. Despite the significant challenges retailers have encountered thus far in the grocery delivery business, ample opportunity exists for players with a comprehensive understanding of current unit economics and an incisive strategy focused on relevant urban markets. ■

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4. *Instacart has hiked delivery fees from $3.99 to $5.99, and its annual fee from $99 to $149, while cutting pay for delivery workers. Source: Primack, Dan. "Instacart Is... Generating Profits?" 24 March 2016. Accessed 14 December 2017. Available http://fortune.com/2016/03/24/instacart-profits/.*

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12. *Hamstra, Mark. "AmazonFresh exits several geographic areas." Ibid.*