Bloomberg Businessweek

Companies & Industries

http://www.businessweek.com/articles/2014-01-16/why-2014-will-finally-be-the-year-of-the-online-grocer

Why 2014 Will Finally Be the Year of the Online Grocer

By Hannah Clark Steiman January 16, 2014

Some people go to bars or clubs on weekend nights. I go to the grocery store. I love to mosey through the aisles, looking for new snacks, picking up five apples before I decide on the right one. I'm apparently not the only one. On a recent Friday night at the Whole Foods (WFM) in Cambridge, Mass., I encountered a pair of musicians, on flute and classical guitar, playing lovely melodies near the wine and cheese section. Clearly, the natural foods chain believes a lot of people see food shopping as entertainment.

Recently, however, disaster struck: I ran out of oatmeal. I realized it would be much easier to order a six-pack of Quaker Oats on Amazon.com (AMZN) than to make an extra trip to the store. I was even willing to eat (shudder) cold cereal for breakfast two days in a row while I waited for delivery. Thus, my pantry entered the Internet age.

My pantry is not alone; 2014 could be the year of online grocery. Traditional brick-and-mortar chains should be worried. The fact that AmazonFresh expanded to two new cities in 2013, after six years operating only in Seattle, is just one cause for concern. Currently, 3.3 percent of total U.S. grocery spending —a $500 billion industry—is online, according to a report from Brick Meets Click. It could reach 11 percent by 2023, a growth rate of nearly 13 percent per year.

Internet sales growth will accelerate as online food prices come down—and they will. Today, brick-and-mortar chains are cheaper than Internet grocers in part because they have economies of scale. Online entrants should be able to match that scale in the long term. Web retailers like AmazonFresh have an advantage: They need only one warehouse in each city where they operate, which is much cheaper than running dozens of stores. While delivery fees add to the cost of online ordering today, new models are changing the game. Relay Foods, an Internet grocer in the Washington, D.C., area, lets customers pick up purchases at a centralized location for free. Ahold USA (AHONY:US), which owns online pioneer Peapod as well as two traditional chains, Giant and Stop & Shop, also offers free pickup in some locations.

As consumers have shifted purchasing preferences, VCs have reopened their minds to the idea of online grocery shopping, after a decade of Webvan-induced fear. In 2009, when Relay Foods first tried to raise funding, nine of 10 investors passed, according to its co-founder and president, Arnie Katz. Now, Katz says, nine of 10 are willing to consider it. In 2013, his company raised more than $8 million. So did Instacart and Good Eggs, while Greenling raised more than $5 million.

Some new entrants have models that will allow them to grow quickly. Instacart and Google (GOOG) Shopping Express deliver food from existing supermarkets instead of their own warehouses, which minimizes capital costs and makes it easier to expand. Instacart also relies on a network of independent drivers, so it doesn't have fleet costs to manage. Started in San Francisco, the company expanded to both Chicago and Boston in the last few months of 2013 and plans to expand to 10 more cities this year.

With the notable exception of Ahold, many grocery executives do not see online delivery as a significant opportunity—or threat. Albertson's, a unit of SuperValu (SVU), ended online delivery in 2009. Kroger (KR) is testing online delivery but is not that worried about the Web, focusing instead on "where our customer is today," a spokesman said recently. Wal-Mart Stores (WMT) is testing the Web as well but has no plans to expand. Supermarket executives seem to agree with Moody's (MCO), which recently noted that online grocery delivery is "unlikely to gain much traction" in the long term.

Focusing on "where the customer is today" would be a fatal mistake for incumbent supermarket chains. Storefront grocers need to take a "dual transformation" approach. They need to enrich their core offerings so they can continue to attract customers to physical locations while they prepare for a world in which a significant portion of grocery spending shifts to the Web.

To strengthen their current model, chains should turn brick-and-mortar supermarkets into destinations, offering free samples, good lighting, friendly staff, and a fun, welcoming environment. Companies such as Costco (COST), Whole Foods, and Trader Joe's are leading in this area; some Whole Foods locations even have bars and pubs. Stores should also offer more high-quality prepared foods to attract consumers seeking to pick up dinner on the way home from work.

And they should offer "destination products" that can't be found anywhere else. This strategy has helped Trader Joe's earn the highest sales-per-square-foot of any grocery chain in the country—$1,750, compared with $972 at Whole Foods and a bit more than $500 for the average supermarket. In addition to its famous private-label wine, Trader Joe's offers its own brand of many foods.

Meanwhile, grocers need to embrace online ordering, especially of nonperishable items. This will be most successful if the online business is managed separately from the core while maintaining access to some shared resources. This gives the new initiative freedom and time to develop a successful strategy. Peapod, for example, is managed as an independent business unit of Ahold, which may explain why it's the largest online delivery service in the U.S. as other efforts from supermarket incumbents have languished.

Companies also need to watch for what's coming next. Many people joked about Amazon's drone delivery announcement, but Jeff Bezos is not a man to ignore. Another player to watch is taxi service Uber, which has a network of drivers in dozens of cities all over the world. The company recently capitalized on that network to offer a Christmas tree delivery service. Could Uber drivers keep milk and other staples in their trunks and deliver them to consumers who order through the Uber app? The next time I'm out of oatmeal, I'd be willing to try it.

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